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Due Diligence and Disclosures

Second Edition

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Introduction

Due Diligence and Disclosures is written for real estate licensees, lenders, attorneys, title officers, buyers and sellers. This course material is designed to be an educational tool to provide an agent with the guidance needed to prepare the forms used to solicit employment, disclose property and transactional facts and to enter into contracts to buy and sell real estate. The scope of the material presented extends beyond a minimum acceptable level of knowledge and professional development.

The objective of this material is to develop the real estate professional's understanding of the use and preparation of forms typically used in general brokerage services, ranging from employment agreements and purchase contracts to disclosures and worksheets.

Included, with an explanation for their use, are forms and notices required when bringing a buyer and seller together as a match in a real estate sales transaction. Forms are treated as itemized checklists of disclosures and provisions to be considered by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect the relevant codes, regulations, judicial decisions and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**.

Chapter 1 — An agent's perception of riches

This chapter examines a worksheet for use by sales agents to analyze the income and expenses they will share or incur during their employment.

The broker avoids deception

An individual receives an original salesperson license from the Department of Real Estate (DRE). The newly licensed agent contacts a real estate broker in response to an advertisement soliciting agents to join his office. The agent will interview this broker, and others, in an effort to find a suitable office in which to work.

Eventually, the agent will select the office he feels is most able to provide the training and guidance he will need to earn a living in real estate sales.

During an *agent interview*, the question of earnings is addressed. The agent is told his employment relationship with the broker will be under an independent contractor (IC) agreement with workers' compensation coverage provided by the broker. No income tax withholding or employer contributions for social security, Medicare or unemployment insurance will exist.

Further, the broker explains the agent will need cash reserves or income from other sources to meet his living and business expenses for six to nine months. Several months will pass before income will be forthcoming from closings in which the agent will have participated. The brokerage office does not make monthly advances against future fees.

To assist the agent in an analysis of his potential earnings, an income and expense data worksheet is prepared by the agent. The agent enters the approximations made by the broker for the various expenses a typical agent should experience during his first year with the brokerage office. [See Form 504 accompanying this chapter]

The agent uses the worksheet to further analyze income, expenses, cash reserves and the sales goal he believes must be met in order to provide an acceptable after-tax income to cover his personal living expenses.

Data underlying an income analysis

As a prerequisite to an agent's use of an income and expense data worksheet, the agent must collect **income data** during his interview with a prospective broker, including:

- the **price range** of property the agent is most likely to list and sell;
- the **number of sales** the agent will likely close in that price range during his first year;
- the **gross brokerage fees** generated by the number of sales during the first year; and
- the **share of the gross brokerage fees** the agent will receive under the fee-sharing schedule proffered by the broker.

The likely **gross fees** the broker will receive and the agent's share of those fees are entered on the worksheet as a result of the interview. [See Form 504 §§1 and 2]

AGENT'S INCOME DATA SHEET

NOTE: This income and expense worksheet is used to assist an agent or associated broker in an analysis of the income and expenses now experienced or likely to be experienced while employed by a brokerage office for the coming one-year period and to estimate the entry or change-of-office costs.

DATE: _____________, 20______

Brokerage office: ____

ANNUAL INCOME AND EXPENSES:

1. Gross Brokerage Fees [See instructions at line 11.4] . . . . $_______________ | 100 %

- 1.1 Franchise fee disbursement (______% of § 1.) (–) $_______________
  - a. Subtotal . . . . $_______________
- 1.2 Broker retains ______% of ☐ §1., or ☐ §1.1a. . (–) $_______________

2. Gross Fees due Agent . . . . $_______________ | ______%

3. Transaction Deductions by Broker:

- 3.1 Less:
  - a. E & O premium ($_______________ per closing) $_______________
  - b. Prior client promotion (______% of fee) . . . . . $_______________
  - c. Listing/Transaction coordinator . . . . $_______________
  - d. Other _____________________________ . . . $_______________
- 3.2 Total charges withheld . . . . (–) $_______________ | ______%

4. Office Expenses:

- 4.1 Equipment rent . . . . $_______________
- 4.2 Forms & manuals. . . . . $_______________
- 4.3 Desk space and parking charges . . . . $_______________
- 4.4 Membership:
  - a. Trade association. . . . . $_______________
  - b. MLS fees. . . . . $_______________
  - c. Affiliations . . . . $_______________
- 4.5 Supplies/software updates . . . . $_______________
- 4.6 Postage/delivering services . . . . $_______________
- 4.7 Library/subscriptions. . . . . $_______________
- 4.8 Photocopies. . . . . $_______________
- 4.9 Equipment use charge . . . . $_______________
- 4.10 Total office expenses: . . . . (–) $_______________ | ______%

5. Agent's Business Expenses:

- 5.1 Telephone:
  - a. Phone/fax . . . . $_______________
  - b. Cell phone . . . . $_______________
- 5.2 Auto:
  - a. Gas/oil. . . . . $_______________
  - b. Repairs and maintenance/carwash . . . . $_______________
  - c. Insurance . . . . $_______________
  - d. Loan/lease payment . . . . $_______________
  - e. Registration . . . . $_______________
- 5.3 Printing:
  - a. Farm letters . . . . $_______________
  - b. Postage . . . . $_______________
- 5.4 Licensing fees and education . . . . $_______________
- 5.5 Internet service . . . . $_______________
- 5.6 Legal and accounting . . . . $_______________

5.7	Marketing sessions	$________		
5.8	Travel/hotel	$________		
5.9	Entertainment	$________		
5.10	Insurance (business and health)	$________		
5.11	Total Business Expenses		(–) $________	____%
6.	**Marketing and Sales Expenses:**			
6.1	Printing flyers/mailer for listings	$________		
6.2	Property ads:			
	a. Newspaper/magazine	$________		
	b. TV/radio/web	$________		
6.3	Postage (marketing)	$________		
6.4	Property preparation	$________		
6.5	Open house (food/drinks)	$________		
6.6	Gifts on closing	$________		
6.7	Transactional expenses	$________		
6.8	Total marketing and sales expenses		(–) $________	____%
7.	**Agent's Net Income:**		$________	____%
7.1	Income, SS & medicare taxes		(–) $________	____%
8.	**Agent's After-Tax Income**		$________	____%

9. Other Income Sources:

9.1	Draw/Advance	$________
9.2	Other ________________	$________
9.3	Other ________________	$________

10. Cost-of-Entry/Change-of-Office Analysis:

10.1	Marketing course	$________	
10.2	Lock boxes	$________	
10.3	Open house signs	$________	
10.4	Stationary/cards	$________	
10.5	Computer/programs/printer	$________	
10.6	Office furniture	$________	
10.7	Photocopier	$________	
10.8	Phone/fax equipment	$________	
10.9	Phone installation	$________	
10.10	Camera/printer	$________	
10.11	Vehicle	$________	
10.12	Other ________________	$________	
10.13	Other ________________	$________	
10.14	**Total Entry/Relocation Costs:**		$________

11. Gross Brokerage Fee Projection/Forecast:

11.1 Annual after-tax income desired by agent. . . . . $________

11.2 Divide by percentage of after-tax income at §8. . . . . (÷)________%

11.3 Annual Gross Brokerage Fee needed at §1.
to earn the desired after-tax income at §11.1: . . . . (=)________

11.4 Analyze the source of Gross Brokerage Fees at §1 by setting the price of the typical transaction Agent will close, the dollar amount Broker will receive as the Gross Brokerage Fee on the typical transaction, and the number of typical transactions Agent must close within one year to attain the Gross Brokerage Fees set as the goal at §11.3.

____
____
____
____.

Ultimately, the **sales goal** set by the agent reflects the amount of after-tax income the agent seeks for himself. [See Form 504 §11]

Until the worksheet is filled out accurately, projecting fees to be received by the agent, estimating expenses to be incurred and attempting to set sales volume goals or probable after-tax earnings is an uneducated guess.

The agent's personal role

The volume of real estate sales closed by new agents during their first year in the business is a "numbers game." Only a percentage of all sales efforts comes to fruition in the form of fees received from closings. Thus, the type of person attracted to real estate sales must have an innate curiosity and enthusiasm for estimating and forecasting income and expenses if he is to succeed.

A prospective agent who is discouraged or daunted by the exercise of completing a worksheet is unlikely to be a prime candidate for employment in the real estate brokerage business.

The broker steps forward

Brokers, by experience, tend to be more organized than agents. Also, brokers who employ agents tend to be better able to anticipate the income and expenses an agent will incur than recently licensed agents. It is the broker who can best draw a conclusion about an agent's future with the broker's office, not the agent who is new to the world of real estate sales or who is now languishing in another office due to inadequate or nonexistent planning.

A broker's primary objective when hiring agents is to increase the gross brokerage fees received by his office without a disproportionate increase in his operating expenses. For the broker to make hiring a productive endeavor, the broker must strive to avoid the constant **turnover of agents** who remain with the office for only a short period of time.

Long-term employment of agents not only contributes to a favorable industry-wide reputation about the broker, but also provides a return to the broker for his time and energy invested with each agent during the employment process and the agent's start-up period. Energy, money, time and enthusiasm all wane fast when the turnover of agents in an office is due to the failure of unrealistic expectations held by the agents.

A broker's full disclosure, upfront and prior to employment, covering the agent's likely income and expenses, and why the sharing and allocations are reasonable, will lead to a realistic expectation of income by the agent. Monthly and quarterly sales goals can then be set at levels designed to meet projected earnings should the agent be employed by the broker.

To control the agent's interview and get long-term results, the broker should initiate the income and expense discussion himself, not wait until the prospective agent takes charge by raising the question of earnings.

To be ready for an interview with a prospective agent, the broker should himself prepare a worksheet by estimating the expenses the agent is most likely to incur. Also, the broker needs to estimate the initial **cash investment** the prospective agent will be required to make to cover one-time, nonrecurring expenditures and carrying costs necessary to get a proper start in real estate sales. [See Form 504 §10]

Once the operating expenses, nonrecurring costs and carrying costs incurred by the typical agent have been established — based on the broker's history with his present agents — what remains is the difficult

task of anticipating an agent's gross fees from sales which will close during the first year of employment.

Forecasting gross fees

A couple of approaches for estimating future fees are apparent. For one, the broker can project a range of gross brokerage fee amounts, varying from the earnings generated by a high producer to those of a low producer during their first year with the office. The various gross brokerage fee projections, ranging from low, medium to high, could be entered on separate but duplicate copies of the income and expense worksheet. The agent's expenses estimated for the first year would also be included in the worksheets.

Thus, the prospective agent's after-tax income can be calculated based on various levels of sales.

Another approach for the interview is to discuss the range of gross brokerage fees an agent can generate, without the broker first entering any fees on the income and expense worksheet he hands to the agent. Thus, the agent is left to enter and calculate the income he either believes he can produce or wants to produce to attain the after-tax income he seeks.

Reviewed by the broker and the prospective agent under either approach, or a combination of approaches, the worksheet becomes both a **budget and a sales goal** for the agent. With an open-minded review of the pros and cons of income sharing and expense allocation, the broker encourages the agent to set attainable production goals.

At the same time, the broker confirms whether the prospective agent has the financial capacity to carry his personal and business expenses during the start-up period with the office before the fees from closings come rolling in.

A failure to inform

An employing broker must inform a prospective agent about the operating expenses the agent will most likely incur while employed by the broker. Also, the agent will need to have a vehicle, computer, and instruments and materials required of real estate sales, as well as pay multiple listing service (MLS) fees. An explanation of the net operating income (NOI) from sales the agent can expect to receive cannot be overlooked by the broker. Without these disclosures, an analysis of the agent's long-term potential with the office has not taken place.

At worst, the failure to advise a prospective agent is an omission of facts known to the broker, which, when discovered by the sales agent, will lead to either a termination of employment or dissatisfaction over lost expectations.

Thus, a realistic and relatively accurate disclosure of income, expenses and the initial investment an agent will incur in the employ of the broker will:

- reduce the office turnover of agents;
- reduce the broker's investment of time and energy hiring and training agents; and
- produce a sales staff whose income expectations will be met due to their ability to most likely attain the sales goals each have set for themselves.

Selecting a broker by comparison

After a few years of employment in the business of real estate sales, efficient agents generally want to earn more for the time they spend listing properties, locating buyers and engaging in all the activities surrounding the sale of a parcel of real estate.

Before walking into the broker's or manager's office with a demand for the office to cover more expenses and give the agent a larger share of the brokerage fees, the agent should first do a little **comparative shopping** to determine how other brokers share expenses and fees with their agents.

The first step for the agent interested in renegotiating his current employment arrangement with his broker or moving to another broker's office, is to prepare a worksheet on his current operating conditions. Just what fees the agent has generated, the share of the fees the agent received, the operating expenses paid by the agent and the net income, as well as the after-tax income experienced during the past 12-month period, is a requisite for any comparison.

If the exercise goes no further, the worksheet can act as a **budget** or a basis for forecasting the next 12 months. Further, the variables controlling the amount of income and expenses can be analyzed, adjusted and projected to set sales goals the agent would like to attain during the next 12 months.

The second step is to distinguish the agent's current arrangement with his broker from the earning opportunities available to him with other acceptable brokerage offices. The comparative analysis is accomplished by preparing a worksheet for each prospective office. Information for the worksheet may be gathered from interviews with those brokers or their managers, or agents in those offices who have a handle on their income and expense arrangements with their broker.

On completion of the worksheet for each office, a comparison shows up the distinctions and parallels between the different offices.

Armed with comparisons reflected by the data developed on the worksheets, the agent seeking to renegotiate fee splits and the allocation of expenses with his current broker can structure his request for specific changes based on the market place.

Alternatively, the agent seeking to change offices uses the worksheet to make the same comparisons and size up prospective brokerage offices. Ultimately, the agent hopes to negotiate an income and expense sharing arrangement which satisfies the agent and provides a better opportunity for greater earnings — expectations realized based on comparison shopping and the agent's past sales history.

However, timing is important. The period during which the agent begins negotiations with his current broker or schedules interviews with other brokers can effect his results.

For instance, at the height of a booming market, a broker will be more willing to increase a productive agent's share of the fees since the broker's current overhead is already covered without the fees from additional sales. The agent's advantage of a better fee split and cost allocation would carry over into the inevitable slowdown in sales which follows every boom.

Conversely, a new agent entering an office during a recessionary period just prior to an upswing in sales will benefit from the broker's attention to the care and training of new agents. Also important is the invaluable assistance of experienced agents in the office who will have a little extra time on their hands. All have time in a slower market to assist others, a bonding process important for a successful future in real estate sales in the coming years.

Chapter 2 — The MLS environment

This chapter discusses the role multiple listing services (MLSs) have had, and continue to have, on the residential brokerage community.

An industry-wide misconception

In everyday practice, sales agents who work with buyers on behalf of their brokers are commonly referred to as "buyer's agents" or "selling agents." However, in legal terms, it is the brokers employed by the buyers who are the **buyer's agents**. [Calif. Civil Code §2079.13(n); see **first tuesday** Form 305 §3]

Historically, and incorrectly, the broker and his agent who represented a buyer in a sales transaction have been referred to as *subagents* within the residential multiple listing service (MLS) brokerage community. The misnomer was a product of the pre-1980s MLS environment, which held that all brokers (and their agents) who were members of a trade union's MLS were automatically "seller's agents."

The basis for the rationale rested on the premise that the sole purpose of the MLS was to **locate a buyer** for those sellers whose properties were posted in the MLS. Thus, all MLS members were said to be working either as the listing agent or a *subagent* of the seller, **employed to sell** the property listed in the MLS.

Accordingly, the MLS member who produced the buyer was improperly viewed as **appointed** by the listing agent to act on behalf of the seller by virtue of:

- the MLS membership; and
- the authority granted by a **subagency provision** in the listing agreement of the day.

Thus, the buyer of a property published in the MLS was without representation since no member of a trade union MLS could theoretically represent a buyer.

The MLS subagency concept was perpetuated by peer pressure amongst MLS residential brokers to conform to "industry trade standards." Thus, buyers were unable to employ brokers who were MLS members, a situation which often led to an undisclosed dual agency by their agent.

However, the MLS subagency approach to marketing real estate had begun to wane by the early 1980s. By then, brokers who sought to openly represent the best interests of buyers began to classify themselves as *single-agency* brokers. In fact, this single-agency activity was the predecessor of today's openly acknowledged buyer's agent.

The cooperating broker's subagency dilemma

Today, nearly three decades later, the buyer's broker and the broker's agents still sometimes improperly refer to themselves as the *cooperating office* or cooperating agents in a sales transaction.

The term **cooperating** arose out of the old MLS subagency concept whereby the listing broker shared the fee paid by the seller with the buyer's broker. **Fee sharing** is currently authorized by the broker cooperation clause in listing agreements. [See **first tuesday** Form 102 §4.2]

Originally, under the old MLS application of subagency, the existence of the cooperation clause was **essential to the receipt of fees** by those brokers and sales agents who "produced" a buyer since the agent was without a retainer agreement with the buyer and had to get "cooperation" under a fee-sharing arrangement with the seller's broker in order to get paid.

MLS brokers under the MLS subagency theory were not employed to act as an agent for a buyer. The purchase agreement forms used were devoid of fee arrangement provisions in the buyer's offer. Yet, a fee provision in the offer is needed to provide the buyer's broker with the ability to independently set his fee and, if accepted or some other arrangement is concluded, enforce collection of the fee.

All MLS subagency arrangements came to a stop by the mid-1980s when the real estate agency law was enacted and buyer's listings began to be generally used.

Under a buyer's listing, MLS brokers and their agents could now effectively act on behalf of buyers without negotiating a fee-sharing arrangement with the seller's broker, who is the **adversary** of the buyer and the buyer's broker. As a result, buyer's agents began to set the amount of the fee they were to receive (paid by sellers) without the listing agents dictating, managing or controlling negotiations over the amount of the fee buyers were willing to allow their agents to receive.

Selling agent or buying agent

The term "selling agent" also has its roots in the old subagent/cooperating agent MLS environment. At the time, listings published in MLS books were reviewed by members with the intent of "helping to sell" the properties to buyers.

Thus, the nonlisting broker/agent, under prior MLS logic, was the one "selling the property" to a prospective buyer "produced" by the selling agent. However, the buyer's agent was, and still is, **selling nothing at all**. A selling agent acting on behalf of a buyer is locating property and representing his buyer in the purchase of real estate as a "buying agent."

Today, the term "selling agent" has been codified in real estate agency law, as has the term "buyer's agent."

However, use of the term "selling agent" does not always mean the selling agent is the buyer's broker.

For instance, the buyer's agent is **always defined** as a selling agent. However, the selling agent is **not always the equivalent** of the buyer's agent. The term selling agent is also legally defined to include a listing broker or his agent who is in direct contact with a buyer, whether or not the listing agent has obligated himself as a dual agent to act as the representative of the buyer.

Representing the buyer requires the agent to locate suitable property and to carefully and diligently advise the buyer on the nature of the property. Also, if an agent represents a buyer, he must seek the most advantageous price and terms available to the buyer when negotiating the acquisition of property.

Thus, when no other broker is involved in a sales transaction, the **listing broker** is also legally referred to as the *selling agent*, a situation referred to in practice as "double ending" the sale.

The listing broker who **double ends** a transaction is not the buyer's agent at all. However, the listing agent may undertake the representation of the buyer to locate and advise on the acquisition of suitable property, in which case the broker is also a dual agent. A buyer's agent absolutely represents the best interests of a buyer. This is not always so when classified as a selling agent.

In a real estate sales transaction, the agent identified and referred to as the **buyer's broker** or buyer's agent is known to all persons, be they judges, legislators, sellers, buyers, lenders, escrow officers or even fellow licensees, as the agent exclusively representing the buyer.

The title "buyer's agent" is now, but has not always been, conceded by the real estate profession to be an appropriate reference to the buyer's representative. However, the clarity and ease of its use is both undeniably generic and persuasive, and indicates the *special agency duties* owed by a buyer's agent to the buyer in a sales transaction. This attitude is lost by use of the nebulous and multifaceted term, selling agent.

Competition vs. price fixing

In 1955, a group of California residential MLS brokers agreed the fee to be charged a seller on all home sales was to be 6% of the price paid by a buyer. This 6% rate of compensation met little resistance from anyone for the next 20 years, even though the price fixing scheme of "same-percentage, same-split" arrangements had already been ruled a violation of federal antitrust laws.

However, the unionized residential MLS brokers did not comply with court orders. To enforce the price fixing 6%/50:50 fee split, the residential brokers used the MLS they controlled to require brokers to publish listing information on the MLS. Included was the total fee agreed to by the seller (and it was to be 6%), with a share (3%) to be retained by the listing broker and a share (3%) to be paid to the buyer's broker.

In this fashion, the seller's broker submitting a listing to the MLS was policed by all other brokers and agents for conformance to the 6%/50:50 policy of fixed fees and sharing. If a seller's agent did not comply, all the other (fee-fixing) MLS brokers and their agents were instructed by the trade union to either refuse to deal with the nonconforming office or to unilaterally refuse to share fees (50:50) on the sale of their listings with the offending, nonconforming listing broker.

More financially persuasive, the residential broker's trade union arbitration board would (and did) enforce the 6%/50:50 rule. Thus, after a short period of fellow-broker inflicted financial injury, the fee-cutting (and successfully competitive) listing office, derogatorily called a *discounter*, would eventually capitulate to the 6%/50:50 routine or go out of business. [**People** v. **National Association of Realtors** (1981) 120 CA3d 459]

Enforcement by residential brokers of the 6%/50:50 rule was made possible through *binding arbitration*. The local trade union owned or controlled the MLS. More insidious, compulsory membership in one (the trade association with its binding arbitration agreement) was then a requisite to admission to the MLS.

Thus, when a broker using the MLS violated its price-fixing policies regarding fees, the trade association became the instrumentality used by conforming brokers to enforce the patently illegal **price fixing activity** by a money award in arbitration. The award was followed by an automatic court-ordered money judgment for enforcement against the competitive fee-cutting, discount broker.

In California, MLS subscribers no longer need to become members of a trade association in order to post listings and access the MLS database, even if the MLS is owned by the association. Thus, the MLS subscriber avoids the suppressive instrumentality of trade association membership. [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

MLS fees fixed and competition banned

Consider a group of local real estate trade associations who each operate their own multiple listing service (MLS). Each association provides their own MLS support services to their subscribers. They also set the price for these support services independently, based on cost. Some are efficient and very successful at providing these services, incurring less than $10 in total costs per subscriber monthly. Others are inefficient and incur costs of $50 per subscriber monthly to provide their MLS support services.

The associations then form a separate corporation in which they are shareholders in order to create and operate a county-wide MLS. Each association is independently contracted by the corporation to provide MLS support services for the subscribers to the new regional MLS.

To assure the continued financial viability of those associations with disproportionately higher operating costs for their inefficient servicing of their MLS subscribers, the associations collaborate to set the minimum fee all associations will charge at $25 per subscriber monthly. The less efficient associations are paid a fixed monthly **cash subsidy** on top of the support services fee without which they would be providing these services at a loss. With the **fee fixed** for services, the efficient associations agree not to charge less and compete to deprive the less efficient associations of subscribers.

Competitive organizations may **join together** to eliminate their separate MLS database operations in favor of a single county-wide MLS. The resulting MLS is more **effective** — greater regional coverage and more **efficient** — reducing the need of brokers to subscribe to two or more MLS database services.

However, the question then arises as to whether they can *collude:*

- to set the fee charged for the MLS services each MLS will provide; and
- to ban any discounting or rebates by the efficient and more competitively operated associations.

The simple answer is no. Price fixing is illegal!

The fee which reimburses the associations for the cost of their MLS support services cannot be legally set by agreement between the competing associations. This is especially true when the larger, more efficient associations then received millions of dollars from their members in increased MLS support services fees for exceeding the actual cost they incurred to provide those services.

This arrangement provided the large associations with huge financial rewards at the improper expense of their member subscribers. [**Freeman** v. **San Diego Association of Realtors** (9th Cir. 2003) 322 F3d 1133]

It was the likelihood that some of the associations would go out of business under an efficient county-wide MLS which led to the price being fixed at a *supra-competitive* and illegal level in the first place. This led to the banning of competitive pricing for MLS services provided to subscribing brokers by the MLSs agreeing to no discounts or rebates for their broker-subscribers (which would have reflected the actual costs of an association).

However, competition or *economic darwinism* must be allowed to occur by the process of *creative destruction*. Under open market conditions, the more efficient associations would have brought about the demise of the less productive associations to the financial benefit of all the MLS users within the enlarged servicing area.

Chapter 3 — Subagency and dual agency

This chapter analyzes the conduct of a subagent in contrast to the conduct of a dual agent, and distinguishes fee-sharing/broker-cooperation arrangements from both.

Agency and fee sharing misconceptions

Payment by a seller or listing broker of the brokerage fee earned by a buyer's broker in a real estate transaction in no way determines the **agency relationship** of the buyer's broker and his agents to either the buyer or the seller.

Thus, neither a *subagency* nor a *dual agency* relationship is created between the seller and the buyer's broker simply because the seller pays the buyer's broker a fee. This fee-agency rule applies whether the seller pays the fee directly to the buyer's broker, or it is paid to him indirectly from the fee received by the seller's/listing broker. [Calif. Civil Code §2079.19]

Conversely, the buyer's broker does become a dual agent should the wording of the seller's acceptance provision in a purchase agreement state the seller **employs** the buyer's broker as part of the seller's provisions for payment of fees.

However, in practice, brokers and agents working for buyers to locate suitable property rarely consider themselves agents of the seller when they show their buyers properties listed with other brokers. They also do not normally conduct themselves as *subagents* of the seller or as *dual agents* representing both seller and buyer.

Subagency: MLS membership myth

The mere membership of a buyer's broker in a multiple listing service (MLS) never creates a dual agency or subagency relationship with any of the sellers represented by other broker-members who publish listings of property for sale in the MLS. Agency, whatever the type, is created either by contract or by the **conduct of each broker** (and his agents) when interacting with a buyer or seller in a transaction, not by trade memberships or the seller's payment of the fee. [CC §2307]

Subagency duties differ greatly from misleading MLS subagency concepts. "MLS subagency" arose out of notions held about the nature of *cooperation* between brokers in fee-sharing arrangements. The focus within the MLS for determining agency relationships was improperly placed on the relationship between the brokers, which overlooked the principal- to-broker relationships in transactions.

For example, when an MLS selling broker (erroneously) believes he is a "subagent" in a transaction on property listed in the MLS by another broker, the critical brokerage facts include:

- the broker working with the buyer is an MLS member;
- the buyer has been assisted by the broker (or the broker's agents) to locate qualifying properties for the purpose of purchasing one which is suitable;
- the buyer has signed a purchase offer prepared by the broker to buy property listed with another broker who is also an MLS member; and

- the brokerage fee due the broker will be paid from funds accruing to the seller based on an agreement made by the listing broker in MLS publications to share his fee with any broker-member who submits an offer from a buyer at the listed price.
- Again, the buyer's broker does not become a subagent of the seller due to the sharing of the fee, unless he **conducts himself** as the seller's representative in negotiations without undertaking any agency duties to represent and negotiate on behalf of the buyer.

It is instructive to observe that a buyer's broker shares fees with the listing broker, not duties. The buyer's broker is not mandated to perform a **visual inspection** and disclose his observations on behalf of the seller as required of listing agents, legal subagents and dual agents.

Subagent vs. fee-sharing broker

A seller's listing agreement authorizes the listing broker to cooperate with other brokers and to divide with them any brokerage fee due under the listing. [See **first tuesday** Form 102 §4.2]

Today, listing agreements no longer include wording which also authorizes the seller's listing broker to delegate to other brokers the authority to **also act** on behalf of the seller as the seller's agent to **locate buyers** and obtain offers to purchase, an activity legally establishing a *subagency* with the seller.

However, should a provision in a listing agreement actually authorize the listing broker to create a subagency, the listing broker may then act on behalf of the seller to employ another brokerage office as a *subagent* to help market the property.

It is beneficial to understand the circumstances under which a buyer is handled when a subagency exists so the multitude of real estate agency roles available in California can be better appreciated.

Subagency facts in a purchase agreement setting typically include:

- two separate brokers, one being a seller's listing broker and the other broker referred to legally as a "selling broker" (since he has contact with a buyer);
- a seller who is exclusively represented by the listing broker; and
- a buyer who is not represented by the selling broker (and may or may not be represented by yet another broker.

Dual agency as an authorized practice

Simply put, a *dual agent* is a broker who is acting as the agent for the **opposing parties** in a transaction, e.g., both the buyer and the seller. [CC §2079.13(d)]

The problem with dual agents is not that dual agency is improper. Dual agency has always been and is proper brokerage practice. However, what is improper is failing to confirm the existence of a dual agency in the agency confirmation provision of a purchase agreement for a one-to-four unit residential property. [CC §2079.17]

Further, a broker on any type of real estate transaction who fails to promptly disclose his dual agency at the moment it arises is subject to:

- the loss of his brokerage fee;
- liability for his clients' money losses; and
- disciplinary action by the Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(d)]

For example, a buyer's agent locates property his buyer is interested in purchasing. The agent then negotiates and receives a written listing agreement from the seller without first disclosing his agency relationship with the buyer. The buyer then makes an offer, which the seller accepts. In the offer, the seller agrees to pay the broker a fee. Again, there is no disclosure of the agency relationship with the buyer.

Before closing, the seller discovers the broker's prior relationship with the buyer and cancels payment of the brokerage fee. The broker demands his fee for locating the buyer.

Here, the broker cannot recover a brokerage fee. The broker intentionally failed to disclose his **dual agency** to the seller at the moment it arose, i.e., at the time he entered into the listing with the seller. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

Also, once a broker becomes a dual agent, he (and his agents) too often do not know how to perform as a dual agent, usually due to a lack of training.

Both clients are entitled to advice

A rule of sorts for disclosure of relevant facts about the transaction, which are known or come to the dual agent's attention either before or after acceptance of an offer, is to advise both parties of the facts by written memorandum, and keep a copy of the memo in the client's file.

However, when a dual agency is established in a one-to-four unit residential sales transaction, and both parties are represented by the same broker, the broker (and his agents) may not pass on any information relating to the **price or terms of payment** from one party to the other. What price the buyer may be willing to pay, or the seller may be willing to accept, must remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question. [CC §2079.21]

Thus, without authorization, the dual agent is now a "secret agent." He must keep secret the minimum pricing sought by the seller and the maximum pricing obtainable from the buyer.

The decision not to release pricing information must be made and maintained from the moment the dual agency arises. The dual agency typically occurs when the buyer who is an existing client is exposed to property listed by the broker — a moment which always occurs before the purchase agreement is prepared and the resulting agency relationships are confirmed.

The written authority needed to advise the seller of the buyer's willingness to pay more, or the seller's willingness to accept less, is best documented on a **modification of listing** form signed by the client whose confidential pricing information is to be released to the other client. The authority would be given to the broker who would retain the document in his file. [See **first tuesday** Form 120]

Dual agency and diminished benefits

Generally, the clients of a dual agent do not receive the full range of benefits they would have obtained from an exclusive agent. The conflicts which exist in a broker's dual representation rule out aggressive negotiations to obtain the best business advantage for either party. This holds true even if different (listing and selling) agents employed by the **same broker** each work with different parties to the same transaction.

While a broker owes his client the duty to pursue the *best business advantage* legally and ethically obtainable through negotiations and agreements, the dual agent is foreclosed from achieving this advantage for either client. The dual agent cannot take sides with one or the other during negotiations.

Thus, a natural inability exists to negotiate the highest and best price for the seller, and at the same time, negotiate the lowest and best price for the buyer. Further, the broker and his agents, while acting as dual agents, are precluded in sales transactions on one-to-four unit residential property from discussing pricing without prior written approval.

The *legal agent* for a buyer or seller in a transaction is the broker, not the broker's agents or brokers employed by the broker who are in contact with the principal. Inhouse transactions which involve the broker as a dual agent make it particularly difficult for the broker to oversee and supervise dual agency negotiations.

Typically, one agent employed by the broker acquires the listing from a seller while another agent in the broker's employ works separately with a buyer to locate qualifying properties listed with other brokers.

The broker becomes a dual agent the moment the buyer is then shown an in-house listing.

However, an improper tendency in transactions involving only one broker and two of his agents who are separately working with a seller and buyer in a sale is to automatically designate the broker as a dual agent.

In fact, the buyer may well be a party to whom no agency duties are owed by any broker or agent. The buyer may have simply responded to the broker's "For Sale" sign, open house or ads marketing the listed property. And without being shown unlisted properties or properties listed with other brokers, the buyer may make an offer on an "in-house" listing through an agent employed by the broker who is not the listing agent.

When the buyer's inquiry and review of properties is limited to properties listed with the broker, the sale of an in-house listing directly to a buyer who has not retained a broker to represent him does not, without more, create an agency relationship with the buyer. [**Price** v. **Eisan** (1961) 194 CA2d 363]

However, there remains, as always, the listing broker's *general nonfiduciary duty* to disclose material facts about the listed property to all parties, including the non-client buyer. Facts to be voluntarily disclosed include the condition of the property's physical aspects, and the natural and environmental hazards of the location that may have an adverse effect on its value or might otherwise affect the buyer's decision to purchase the property. Further, there are always the disclosures made by the agents in response to any inquiry by the buyer.

Chapter 4 — Conflict of interest

This chapter demonstrates a broker's use of a Conflict of Interest Disclosure to avoid breaching the fiduciary duty he owes to his client when he has a bias relating to the opposing party in a transaction, or another, whose interests are in conflict with his client's.

Professional relationships compromised

A conflict of interest arises when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

In a professional relationship, a broker's financial objective of **compensation for services** rendered by the broker is not a conflict of interest. However, fees and benefits derived from professional courtesies, familial favors, and preferential treatment by others toward the broker or his agents is compensation which must be **disclosed** to the client. [See Form 119 accompanying Chapter 8]

Further, the referral of a client to a financially controlled business, owned or co-owned by the broker, must be disclosed by use of an affiliated business arrangement (ABA) form, and is also not a conflict of interest. [See **first tuesday** Form 519]

A **conflict of interest** addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental *agency dilemma* for brokers, not a compensation or business referral issue. A **conflict of interest** exists when:

- a broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and
- that bias in favor of or against the other person might *compromise* the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

This bias regarding an opposing person or a party not directly involved, to whom the broker may or may not also owe an agency duty, must be disclosed if the bias might disrupt the broker's ability to make impartial decisions about the care and protection he owes his client. Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing, and trust owed to his client should the broker continue to act on the client's behalf. [See Figure 1 accompanying this chapter]

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction, revealing to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. Though the disclosure and consent does not neutralize the *inherent bias* itself, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a **conflict** that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect *ownership interest* in the real estate, or are directly or indirectly a buyer of the property in the transaction, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;
- an individual related to the broker or one of his agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;
- an individual with whom the broker or a family member has a *special pre-existing* relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;
- the broker's or his agent's concurrent representation of the opposing party, a *dual agency situation*; or
- an *unwillingness* of the broker or his agent *to work* with the opposing party, or others, or their brokers or agents in a transaction.

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a *pre-existing relationship* with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties, or any other socio-economic context; and
- that relationship might hinder his *ability to fully represent* the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, he should disclose it. The existence of any concern is reason enough for a prudent broker to be prompt in seeking his client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

The client's tardy discovery of the conflict and their complaint to the Department of Real Estate (DRE) for failure to make the disclosure and obtain consent before continuing to advise or act on behalf of the client can result in the suspension or revocation of the broker's license by the DRE. [Calif. Business and Professions Code §10177(o)]

Fundamentally, a broker who becomes aware he has a conflict of interest but is reluctant to disclose it and seek the client's consent should consider rejecting or terminating the employment with that individual.

Relative's participation in a transaction

A seller's broker must disclose the broker's acquisition of any direct or indirect interest in the seller's property, or whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker (such as his agents) will acquire an interest in the seller's property. [See **first tuesday** Form 527 §3.6]

For example, a broker's brother-in-law makes an offer to buy property the broker has listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

Figure 1

CONFLICT OF INTEREST
(Kinship, Position or Undue Influence)

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: _____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:
☐ Listing (Employment) Agreement ☐ Purchase Agreement
☐ Escrow Instructions ☐ ______________________
1.1 ☐ of the same date, or dated _____________, 20______, at ___________________________, California,
1.2 entered into by ____, as the ___________________, and
1.3 ____, as the ___________________,
1.4 regarding real estate referred to as ____.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the ____.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate
Property type: ____
Address: ____
Interest held: ____
Activity creating conflict: ____

3.2 ☐ Government agency
Agency name: ____
Position held: ____
Activity creating conflict: ____

3.3 ☐ Business position
Business name: ____
Goods or services provided: ____
Position held: ____
Activity creating conflict: ____

3.4 ☐ Business investment
Company name: ____
Type of trade or business: ____
Interest held: ____
Activity creating conflict: ____

— — — — — — — — — — — — — — — — — — — PAGE ONE OF TWO — FORM 527 — — — — — — — — — — — — — — — — — — —
— — — — — — — — — — — — — — — — — — — PAGE TWO OF TWO — FORM 527 — — — — — — — — — — — — — — — — — — —

3.5 ☐ Representation of others in transaction
Name of person also owed agency duties: ____
Activity creating conflict: ____

3.6 ☐ Kinship and employee relationships
Name of individual(s): ____
Relationship with Broker or employee: ____
Activity creating conflict: ____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.
Date: _____________, 20______ Broker's Name : ____
By: ____
Agent's Name: ____

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.
☐ See attached Signature Page Addendum [**ft** Form 251]
Date: _____________, 20______
Name: ____ Name: ____
Signature: ____________________________________ Signature: ____________________________________

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The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest, a syndicated acquisition. Both escrows close and the broker receives his fee.

The seller discovers the buyer to whom he deeded the property was his broker's brother-in-law and that the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

Here, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received, or he can set the sale aside, due to the failure of the broker's agency with the seller.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his **dual role** and obtaining the **client's consent** at the time the conflict arises. [Bus & P C §10176(d); see **first tuesday** Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer, even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

In another example, a seller, acting on a broker's advice as to the estimated value of his real estate, retains the broker to find a buyer for the property. [See **first tuesday** Form 318]

The broker and seller enter into a net listing agreement.

Under the **net listing**, the seller agrees to take a fixed sum of money as the net proceeds for his equity should the property sell. Also, the net listing provides for the broker to receive all further sums paid on the price as his brokerage fee.

The broker arranges a sale of the property to his daughter and son-in-law. The seller is not informed of the broker's relationship with the buyer. On the close of the transaction, the broker receives his fully disclosed brokerage fee as the net proceeds remaining from the sale in excess of the net listing price.

On discovery of the broker's relationship with the buyer, the seller demands a return of the brokerage fee claiming the broker's kinship with the buyer is a conflict of interest which was not disclosed, violating the fiduciary duty he owed to the seller. The broker claims the seller cannot recover the brokerage fee no matter who the buyer was since the seller only bargained to receive a fixed amount on the sale of his property under the net listing agreement.

Here, and whenever a broker is employed under any type of listing, he has an obligation to voluntarily disclose to his seller, and do so at the earliest opportunity, any special relationship he may have with the buyer and obtain the seller's consent before proceeding. The seller, unaware of the **family relationship** between his broker and the buyer, can recover the brokerage fee he paid to the broker. [**Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579]

A relative owns the property sold

A selling broker employed to act on behalf of a buyer will disclose to his buyer the nature and extent of any direct or indirect interest **he or his agents hold** in any property presented to the buyer.

For example, a licensed broker acting as an agent on behalf of a buyer shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker promptly informs the buyer he has a listing on the property, but does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the LLC property. An offer is prepared on a purchase agreement form with an agency confirmation stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See Form 159 accompanying Chapter 35]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer.

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises – the exposure of the buyer to the property. The conflict of interest in the broker's ownership is a material fact requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the lack of disclosure of the conflicting position of the buyer's broker, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, he might have negotiated differently when setting the price and terms for payment, or retained a different broker to represent his interests who was not compromised by a conflict of interest.

However, a broker acting solely **as a principal** in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for his own account should act solely as the seller or buyer, rather than pay himself a taxable fee for **also acting as a broker** in the transaction which then exposes him to claims of agency violations. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

Taking a fee when acting as a principal

When a **broker-seller** receives a brokerage fee on the sale of his own property or on the purchase of property for his own account, he subjects himself to real estate agency requirements.

For example, a broker sells a residence he owns which exists in violation of safety requirements for occupancy due to defects in the foundation known to the broker. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of his property, the broker-seller pays himself a brokerage fee, claiming to *exclusively represent himself* (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects that cause the buyer to take a loss.

The broker is unable to pay the money judgment. The buyer seeks payment from the DRE Recovery Fund.

Recovery is received from the DRE Recovery Fund since the broker held himself out as **acting as a real estate** broker in the transaction – he received a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the DRE Recovery Fund. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The licensee acts solely as a principal

A DRE licensee acting solely as a principal on his own behalf when buying (or selling) property need not disclose the existence of his real estate license. The licensee has no conflict due to the **existence of his license** since he is not holding himself out as a broker or agent acting on behalf of another person in the transaction.

Consider a broker who is employed by an owner to arrange a real estate loan. The lender making the loan is the broker's sister.

The broker, however, funds the loan himself by depositing his personal funds into his sister's account. In essence, the broker is the lender.

The owner is not advised of the kinship between the broker and the lender, or of the true source of the loan funds. [See **first tuesday** Forms 205-1 and 205-2]

Here, the broker has a duty owed to the buyer to disclose his **dual capacity** in the loan transaction. He was acting both as a broker arranging the loan on behalf of the owner and as the lender making the loan, a conflict of interest. The broker's actions constitute grounds for discipline by the Real Estate Commissioner. [**Tushner** v. **Savage** (1963) 219 CA2d 71]

Conflicts in real estate syndication

A potential conflict of interest also exists when a broker **manages multiple LLCs** which own like-type properties in the same market area, the result of his syndicating the acquisition of several properties.

For example, consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market and compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions in which multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in first tuesday Form 371, Investment Circular provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction.

> To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]

With this disclosure, the **broker's allegiance** to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Compensation and earnings received by the broker

Direct or indirect compensation received by a broker must be disclosed to his client but not as a conflict of interest. A Compensation Disclosure form is prepared, setting forth the amount of compensation, its form and source as additional benefits the broker and his agents anticipate receiving for any other service they provide as a result of the client's entry into a real estate transaction in which the broker is acting as a licensee. [Bus & P C §10176(g); see Form 119 accompanying Chapter 8]

.The disclosure enables the broker to indirectly benefit from the referral and properly share in any profits from the referrals he makes to businesses he controls. [See **first tuesday** Form 519]

Similarly, the Affiliated Business Arrangement Disclosure Statement – Loan Broker form is used by a mortgage loan broker arranging financing when referring a borrower to providers of settlement services whose earnings are shared by the loan broker as a co-owner of the provider. [See **first tuesday** Form 205]

Chapter 5 — Greater transparency in marketing

This chapter digests the marketing assistance a seller provides a listing agent by authorizing investigative reports regarding the listed property before it is marketed.

Costs for preparing to sell

An owner of a single-family residence (SFR) wants to list the property for sale with the brokerage office of an agent known to the owner.

The agent prepares an exclusive right-to-sell listing agreement form for review with the owner.

The agent also prepares an addendum (among others) in which he estimates the cost of third-party **investigative reports** needed to provide prospective buyers with information on the property. The reports are those which are always demanded by prudent buyers and careful buyer's agents for confirmation and approval by the buyer before closing escrow on a purchase of property.

The listing agent will present this listing package cost sheet addendum to the owner as a "seller's budget." As a disclosure, it sets the costs of those third-party reports the owner will most likely incur on a sale.

The cost sheet prepared by the agent estimates the cost of investigative reports prepared by other professionals or government agencies which will help put a face on the property so it can be better **evaluated by prospective buyers**. The recommended reports include an occupancy (transfer) certificate (by local ordinance), natural hazard disclosure (NHD), structural pest control report (and possible clearance), home inspection report, well water report and a septic tank report. [See Form 107 accompanying this chapter]

Once the cost sheet is signed by the seller, the agent can then prepare and deliver various authorization requests to third-party service providers to deliver the mandated reports. [See Form 133 accompanying this chapter; see **first tuesday** Forms 124-136]

The reports will become part of the listing agent's **marketing package** for the sale of the listed property. The agent is aware the best way to market property and expose it to a prospective buyer who will actually enter into a purchase agreement without further negotiations prior to the close of escrow is to fully disclose the condition of the property when first dealing with the buyer.

Staging to set the buyer's expectations

Also, a **buyer's expectations** about the property are legally established based on his impression of the property at the time he enters into a purchase agreement, not later after the price has been set, escrow opened and the true condition of the property revealed to the buyer for the first time. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

Here, the owner has to make a choice as to when he will incur the **expense of third-party reports**, be it:

LISTING PACKAGE COST SHEET

Due Diligence Checklist

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is an addendum to an employment agreement referred to as a Seller's Listing Agreement [See **ft** Form 102]

1.2 ☐ of same date, or dated_____________, 20______, at _______________________________, California,

1.3 entered into by ____, as the Broker,

and ____, as the Seller,

1.4 regarding real estate referred to as ____,

1.5 for a period beginning on _____________, 20______ and expiring on _____________, 20______.

2. BROKER'S DISCLOSURE AND PERFORMANCE:

2.1 The items listed below with estimated costs constitute a disclosure of the reports and activities Seller can reasonably expect will be required to either bring about or close a transaction under the employment agreement, and if acquired early, will assist Broker to provide prospective buyers with property information Broker anticipates he will need to effectively perform under the employment agreement.

a. Natural hazard disclosure report . . . . $_______________

b. Local ordinance compliance certificate . . . . $_______________

c. Structural pest control report and ☐ clearance . . . . $_______________

d. Smoke detector and water heater anchor installation . . . . $_______________

e. Property (Home) inspection report . . . . $_______________

f. Association (CID) documents charge . . . . $_______________

g. Lead-based paint report . . . . $_______________

h. Mello-Roos assessment notice . . . . $_______________

i. Listing (transaction) coordinator's fee . . . . $_______________

j. Well water quality and quantity report . . . . $_______________

k. Septic/sewer report . . . . $_______________

l. Soil report . . . . $_______________

m. Survey of property (civil engineer) . . . . $_______________

n. Appraisal report . . . . $_______________

o. Architectural (floor) plans . . . . $_______________

p. Title report: ☐ property profile, ☐ preliminary report, ☐ abstract . . . . $_______________

q. MLS and market session input fees . . . . $_______________

r. Sign deposit or purchase, installation and removal . . . . $_______________

s. Advertising in newspapers, magazines, radio or television . . . . $_______________

t. Information flyers and postage (handout or mailing). . . . . $_______________

u. Open house — food and spirits . . . . $_______________

v. Photos or video of the property . . . . $_______________

w. Credit report on prospective buyer . . . . $_______________

x. Travel expenses . . . . $_______________

y. Other ____ . . . . $_______________

z. Other ____ . . . . $_______________

2.2 **TOTAL ESTIMATED COSTS** . . . . $_______________

2.3 ☐ Broker is hereby authorized and instructed to incur on behalf of Seller the cost estimated above.

3. PAYMENT OF COSTS:

3.1 ☐ Seller agrees to pay, on presentation of a billing, those costs estimated above and incurred by Broker.

3.2 ☐ Broker agrees to incur the expenses of the estimated costs set out and authorized in §2.3 during the first 21 days of the employment and to timely pay the charges. Seller agrees to reimburse Broker for the costs Broker incurs, IF:

a. Seller closes a transaction which is the subject of the employment agreement;

b. Seller terminates the employment agreement by cancellation or by conduct before it expires; or

c. Seller retains another Broker on the expiration of the employment agreement to pursue a transaction which is the subject of the employment agreement with Broker.

3.3 ☐ Costs paid by Seller under this addendum shall be credited toward any contingency fee earned by Broker upon closing a transaction which is the subject of the employment agreement.

3.4 Seller herewith hands Broker a deposit of $_____________ as an advance for the payment of costs incurred by Broker on behalf of Seller as estimated above.

4. TRUST ACCOUNT: (To be filled out only if a deposit is entered at §3.4 above.)

4.1 Broker will place the advance cost deposit received under §3.4 above into his trust account maintained with ____
at their ____ branch.

4.2 Broker is authorized and instructed to disburse from the trust account those amounts required to pay and satisfy the obligations incurred as agreed.

4.3 Within 10 days after each calendar ☐ month, or ☐ quarter, and upon termination of this agreement, Broker will deliver to Seller a statement of account for all funds withdrawn from the advance cost deposit handed Broker under §3.4 above.

4.4 Each statement of account delivered by Broker shall include no less than the following information:

a. The amount of the advance cost deposit received.

b. The amount of funds disbursed from the advance cost deposit.

c. An itemization and description of the obligation paid on each disbursement.

d. The current remaining balance of the advance cost deposit.

e. An attached copy of any advertisements paid from the advance cost deposit since the last recorded accounting.

f. ____
____
____
____
____
____
____
____
____
____

4.5 On termination of this agreement, Broker will return to Seller all remaining trust funds.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____________, 20______	Date:_____________, 20______
Broker's name: ________________________________	Seller's name: ________________________________
By:____	Seller's Signature:____________________________
	Seller's Signature:____________________________

- *now*, when he lists the property for sale, so a purchase agreement entered into with a prospective buyer has a greater likelihood of closing due to the prior delivery of the reports to avert claims of deception about the property's existing condition; or
- *later*, after entering into a purchase agreement with a buyer who has already developed expectations about the property which will probably differ from the reports and, unless the owner repairs the defects or adjusts the price, will likely result in the buyer canceling the purchase agreement or closing escrow and demanding a return of the overpayment in price or the cost incurred for repairs. [Jue, *supra*]

The listing agent meets with the owner to review the listing agreement and its addenda. The cost sheet is presented as an integral part of the agent's **marketing plan** to attract buyers willing to buy the property based on their full knowledge of its condition. The disclosures provide a *competitive sales advantage* over other apparently qualified properties which are marketed without reports to corroborate their condition.

Also, agents representing buyers are attracted to properties offered with all investigative third-party reports handed to them in a complete **listing package** (marketing package). With this package, property disclosures made to buyers through the use of third-party **reports reduce**:

- the seller's exposure to liability under his duty to fully disclose his actual knowledge of the property's condition [Calif. Civil Code §1102.4]; and
- the listing agent's exposure to liability under his duty to personally inspect, observe and report his findings about a property's condition. [CC §2079]

Also, closing escrow on the purchase agreement will not be subject to the buyer's further-approval of the property conditions when all reports are delivered to the prospective buyer prior to entering into a purchase agreement.

The primary marketing advantage for the owner who provides prospective buyers with third-party reports is that the sale of the property is *transparent* at its inception. The price agreed to in the purchase agreement is based on property conditions "as disclosed" by the reports.

Avoided is the undisclosed (and prohibited) "as is" sale which leads inevitably to price renegotiations, repairs, or worse yet for all, cancellation of the purchase agreement or litigation for failing to disclose facts about material defects known when the purchase agreement was accepted. [CC §§1102.1, 2079]

Owner's motivation to sell

An owner's reaction to a listing agent's request for the owner to participate in an advantageous marketing plan by incurring the costs of property reports upfront offers the agent an insight into the extent of the owner's motivation to sell the property. The agent's goal, besides getting a listing, is to encourage and receive maximum cooperation from the owner in the sales effort.

An owner can "dress up " the property and enhance its "curb appeal" by cosmetic painting, landscaping and clean up. However, it is a **property's fundamentals** which generate firm offers to purchase. It is to this end the owner is asked not only to list the property, but to be enthusiastic about disclosing the property's fundamentals to prospective buyers at the **earliest opportunity**.

However, the owner's motivation to sell may have more to do with his lack of available cash for loan payments than his desire to incur the cost of the reports needed to properly market the property. In the case of a financially distressed owner who is unwilling or unable to obtain expert third-party reports, the

AUTHORIZATION TO PROVIDE SERVICES

General Services

DATE: ____________, 20_____. Prepared by ______________________________.

TO:	**FROM BROKER:**
Company name ______________	Agent's name ______________
ATTN ______________	Broker's name ______________
Address ______________	Address ______________
______________	______________
Phone __________ Fax __________	Phone __________ Fax __________
Email ______________	Email ______________

1. Property address ______________________________.

1.1 Type of property:

☐ single family residence, ☐ condo unit, ☐ two-to-four residential units,

☐ ______________________________

2. Owner's name ______________________________

Address ______________________________

Home Phone ______________ Cell Phone ______________

Work Phone ______________ Extension ______________

3. Please provide the following services: ______________________________

____

____

____

____

____

4. Should you need a contract to be executed before rendering your services, it will be entered into by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.

Name ______________________________

Address ______________________________

____

Phone ______________________________

5. Should you need to access the property to provide your services, your contact for access will be ☐ Agent/Broker, or ☐ Owner.

6. The fee for your services will be paid by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.

6.1 Please submit the billing as follows:

a. ☐ To Agent/Broker for payment in full on completion of your services and, if applicable, delivery of any reports or documents.

b. ☐ To Escrow, for payment on the closing of the pending sale.

Escrow company ______________________________

Escrow office ______________________________

Escrow number ______________________________

Address ______________________________

Phone ______________ Fax ______________

6.2 It is anticipated the amount of the fee for your services will be $ ______________.

Submitting Agent's Signature: ______________________________

listing comes with a significant increase in the listing agent's risk of losing a sale due to a buyer's disapproval of contingencies involving in-escrow disclosures.

Also, an owner may not want to disclose the condition of the property until after he accepts a purchase agreement offer from a buyer. He will then make only those concessions necessary to keep the transaction together, or resell the property to a competing back-up buyer who has been fully informed about the property's condition. Such conduct by an owner is deceitful.

Here, the owner knows something fundamental about the property which negatively affects its value and he does not want to tell the buyer before entering into a purchase agreement. He would rather wait to make disclosures after the buyer has committed himself to purchase the property, a type of intentional seller fraud.

The best time for the listing agent to present the owner with the cost sheet is when the listing in entered into. The owner who really wants to sell and not just "test his price" in the market will respond in a positive manner to the agent's advice. If the owner's response is negative, the owner's intentions to quickly enter into a sales transaction with a likelihood of closing are probably suspect.

The owner's negative response to making property disclosures at the earliest opportunity is an indicator of the level of future cooperation in marketing, contracting to sell and closing an escrow which the agent can expect to encounter from the owner.

Brokerage fee considerations

The amount of the brokerage fee sought by a listing agent on a property is implicitly related to:

- the price sought by the owner of the property;
- the time and effort the agent will spend servicing the listing; and
- the probability of actually locating a buyer and closing a sale.

After analyzing these implications, it is the likelihood the property will sell and the broker will receive a fee that causes a broker to agree to a listing in the first place, on terms and for a fee which are reasonable under the circumstances.

Consider a broker who requires his agents to attach a cost sheet to all listings. By including the addendum, the owner will (or will not) authorize the listing agent to order out reports needed to more effectively market the property and screen prospective buyers. The broker requires the cost sheet addendum to increase the productivity of his agents. Property reports reduce the time spent closing a purchase agreement since the purchase agreement has been **preceded by disclosures**, rather than the reverse order of events.

As part of the listing agent's brokerage fee negotiations, the agent is instructed by his broker to get the owner to authorize the immediate purchase of the necessary reports. If the owner concedes the reports are necessary, but wants to wait until a buyer is located, the listing agent might then negotiate terms to acquire the immediate authority to order reports.

As an economic inducement, the broker, through his agent, might offer to **offset the fee** earned on a sale by the amount of the cost of the reports. The broker should never agree to pay the cost of any corrective work undertaken on the owner's property, unless to settle a dispute which exposes the broker to liability. [See Form 107 §3.3]

Alternatively, a reduction in the brokerage fee by one-quarter to one percent, or more, might be offered to induce the owner to assist in the marketing process by paying for the reports now. The reduced fee would reflect the greater likelihood of a successful closing of a sale, devoid of complications before or after closing.

Thus, the fee ultimately agreed to reflects:

- the reduced time and effort necessary to service the listing;
- the reduced risk of loss of the time, effort and money invested in the listing by the broker and the listing agent; and
- a more effective marketing plan, which, on average, will produce more transactions annually for the broker.

Making a sales transaction more transparent for buyers always rewards the brokers and agents for their professionalism in this and future transactions.

Requesting authority

When preparing the cost sheet authorizing the agent to incur the cost for marketing reports, cost estimates will be entered for items which will ultimately be required to close a sale.

An owner who refuses to incur the cost of third- party reports on the sale of his property needs to be advised that a prudent buyer will incur them on the advice of the buyer's agent. In turn, the buyer will inevitably use the reports against the owner as a "punch list" for demanding repairs and replacements to be completed before the buyer will close escrow.

Thus, for an owner selling property, it is best to get the reports sooner rather than later. The same holds true for implementing the listing agent's marketing plan for the property.

It is worth noting that none of the listed items on the **cost sheet** are part of the broker's overhead for maintaining a brokerage office. All the **costs listed**, if incurred, are related solely to establishing the **condition of the property** listed, marketed and sold. They are incurred to establish the condition of the owner's property, not to pay for the services of the broker and the listing agent. Thus, the cost rightly should be paid by the owner and not borne by the broker or the listing agent.

Further, since the reports are of assistance to the listing agent in the marketing of the property, the costs should be incurred by the owner at the time of the listing. Thus, the reports would be received before the listing agent puts the property on the market. It is always helpful to know the nature and condition of the property you are marketing since the knowledge reduces omissions and misstatements. [Jue, *supra*]

Occasionally, a reticent broker or agent will entertain the thought that some brokers do not ask owners for authority to order reports before a property is sold. And since the competition doesn't ask, why should they ask, lest they lose listings to other brokers by asking owners to spend money on property reports. One supposes these reticent brokers and listing agents should then themselves advance the cost of these reports in the hope the property will sell and they receive a fee to cover their advances.

Business cycles in real estate sales may also influence a broker's desire to request authorization to obtain property reports for a listing package. During periods of rising prices, disclosures seem less likely to occur as sellers become greedy and demanding while buyers are anxious and permissive. Both sellers and buyers drop their guard in a deliberate effort to meet their objectives.

Brokers and their agents are too often accommodating of the lax disclosure environment. The failures only lay dormant until the next recession when the inevitable drop in property values bring some of the failures to litigation.

Conversely, during periods of decreased sales volume with buyers more selective and buyer's agents increasingly more protective of their clients, the owner will have to step forward to fund the cost of reports in order to "sell" the property. The listing agent with property reports in hand has a better listing package, and thus a better disclosed and more certain set of property conditions than competing, under-disclosed properties.

When to pay

When filling out the cost sheet, an owner has choices as to when and how he will pay for the cost of the reports.

The owner may agree to pay the charges directly to the third-party vendors when billed, in which case the agent coordinates the arrangements for payment with the vendors. While the owner's check is payable to the vendor, not the broker, if it is handed to the listing agent for delivery to the vendor, the check constitutes *trust funds* which require an entry in the trust fund ledger maintained by the listing agent's broker. [See Form 107 §3.1]

On the other hand, the owner may deposit the estimated cost of the reports with the broker by making the check payable to the broker, called *advance costs*. The broker would then pay the charges from the deposit when billed by the reporting service. [See Form 107 §3.2]

Advance costs as trust funds

Funds advanced by a client directly to a broker belong to the client.

The broker must place all advance deposits received in the broker's name in a trust account, whether they are advances for future costs or fees. [Calif. Business and Professions Code §10146]

The cost sheet authorizes the broker to disburse the client's funds from the trust account only as costs are incurred.

When the listing terminates, the broker must return all remaining trust funds to the client. The broker cannot use trust funds to offset any fees the client still owes him.

At least every calendar quarter, the broker must give the client a statement accounting for all funds held in trust. A monthly mailing of a copy of the client's trust account ledger would create a better business relationship.

A final accounting must be made when the listing agreement expires. Again, if any funds remain in trust, they must be returned to the client with this accounting. [Bus & P C §10146]

The **statement of account** for the trust funds must include the following information:

- the amount of the *deposit* toward advance costs;
- the amount of each *disbursement* of funds from the trust account;
- an itemized *description* of the cost obligation paid on each disbursement;
- the current remaining *balance* of the advance cost deposit; and
- an attached copy of any *advertisements* paid for from the advance cost deposit.

- Lastly, the broker must keep all accounting records for at least three years and make them available to the Department of Real Estate (DRE) on request. [Bus & P C §10148]

A broker who fails to place those advance deposits payable to the broker in his trust account, or who later fails to deliver proper trust account statements to his client, is **presumed** to be guilty of *embezzlement*. [**Burch** v. **Argus Properties, Inc.** (1979) 92 CA3d 128]

Chapter 6 — Sharing fees on a sale

This chapter analyzes the history and current status of fee sharing between seller's agents and buyer's agents on the sale of a home, and the "no-service, no-fee" and controlled business rules for referrals to service providers.

Buyer's agent or cooperating agent?

The characterization of a buyer's agent, in practice, as a cooperating agent is improper. The word "co-operating" lacks descriptive value when the purpose of it is to label the agent or broker involved as the representative of a buyer.

The **plain meaning** of the adjective "cooperating" is of no help in determining any activity other than a collaboration by two brokers to pair their respective clients to make a match for the transfer of property.

For the buyer's agent to tell a buyer, "Oh yes, we cooperate with other brokers on their listings," conveys no thought of fee sharing or the establishment of an agency. The buyer logically only understands that the brokers are **sharing information** in a joint effort to assist the buyer in a decision as to which, of all the prospective properties available, he should buy.

Further, at the judicial level and based on legislation, the *cooperating agent* has been established as the title for a **subagent of the seller**, never a buyer's agent acting exclusively and in the best interests of his buyer. Thus, any use of the title "cooperating (selling) broker" is a legal reference to a subagent acting on behalf of the seller, and if a dual agent, then also on behalf of the buyer.

The codified agency law scheme defines a *cooperating broker* as one acting as a subagent with specific affirmative duties of care **owed the seller**, not the buyer. However, any cooperating broker must deal fairly and in a nondeceitful manner with the buyer, as must also the seller's primary agent. No such severe limitations exists on the duties owed to buyers by a buyer's agent. [Calif. Civil Code §2079.16]

Further, a **subagent** is identified by code as the agent in the sales transaction who *cooperates* with the listing agent **to sell** the property or **to locate** a buyer on behalf of the seller. The real estate agency scheme also labels the subagent as a *selling agent* if, while acting on behalf of the seller, he deals directly with the prospective buyer, there presumably being no buyer's agent. The scheme separates the seller's subagent from any buyer's agent who is engaged by the buyer to locate property. [CC §§2079.13(n), 2079.13(o)]

Thus, the "cooperation" contemplated by the legislature is not the fee-sharing structure employed in the fee-sharing addendum attached to purchase agreements still used by multiple listing service (MLS) residential listing brokers. Brokers and their agents who act exclusively as agents for the buyer and share fees, simply put, are not cooperating brokers.

Unbundled, off-form fee provisions

For a buyer's broker to have **equal ability** to negotiate and collect a fee as a seller's broker:

- the buyer's broker must enter into an employment agreement with their buyer, called a *buyer's listing*, to be assured the buyer will have legal incentive to back up fee demands which the buyer's agent may make on the seller;
- a fee provision must be written into the buyer's *purchase agreement offer*, stating the seller will pay a brokerage fee in an amount set by the buyer's broker and the buyer;
- the fee earned and payable by the seller to the buyer's broker must be *payable directly to the buyer's broker* by the seller, through escrow;
- the seller must agree to pay the fee earned by the brokers should the seller wrongfully *fail to close* the sale so the buyer's broker can pursue collection of his share, no matter the action or inaction to do so by the seller's broker; and
- the buyer must agree to pay the fee earned by the brokers should the buyer unjustifiably *fails to close*, allowing both the seller's broker and the buyer's broker to enforce collection of their respective share of the fee from the buyer.

The payment by the seller of the fee earned by the buyer's broker in no way establishes or indicates an agency with the seller. Thus, no rationale exists to take the payment of the brokers' fees due on the acceptance of a purchase agreement offer "off form," placing it in a separate agreement calling for the seller to pay only the seller's broker. [CC §§2079.16, 2079.19]

However, the buyer's broker may wish to abide by the off-form scheme for payment of his brokerage fee by the listing broker and not the seller directly.

Occasionally, the fee offered by the listing broker through the MLS is less than the amount the buyer's broker feels he is entitled to on the transaction. Here, the buyer's broker is at liberty to negotiate with the listing broker and agree to a different fee schedule than the one offered in the MLS publication, any agreement being in writing.

Thus, on acceptance of the buyer's purchase agreement offer (which is devoid of a fee provision), the buyer's broker is assured that the "off-form" fee agreement will actually provide for the listing broker to pay the agreed share to the buyer's broker. [See **first tuesday** Form 105]

If the buyer's broker does acquiesce to the off-form fee agreement in which he receives his fee from the listing broker, the covert aspect of not letting the buyer know what fees are paid the buyer's broker is a direct violation of the agency rule stating the client is to be informed of all compensation received from all sources by his agent as a result of the representation. [See Form 119 accompanying Chapter 8]

Had the buyer's agent actually been only a *cooperating agent* negotiating the sale of the property to the buyer on behalf of the seller (as a statutory subagent), then the off-form fee arrangement and the non-disclosure to the buyer of the subagent's compensation is of no concern to the buyer. The buyer has no agent, or has his own agent. The seller, as the client of the cooperating (selling) broker, is fully aware of his subagent's compensation since he is agreeing to it.

All distortions and shortcomings in fee arrangements are avoided and the buyer's broker's fee is protected when the buyer's agent simply includes the fee arrangements as a provision in the purchase agreement offer agreed to by the buyer.

A profit, not a referral fee

In times of slowing real estate activity, prudent residential brokers listing a property or representing a buyer can generate additional income by diversifying their brokerage business, becoming *full-service brokers* by referring buyers and sellers to lenders and service providers they own or co-own. These business relationships, called *affiliated business arrangements* or *controlled business arrangements*, properly enable the broker to indirectly benefit by sharing in any profits from the referrals he makes to these controlled businesses.

However, the single-family residential (SFR) broker's ability to **profit from referrals** is regulated by the federal Real Estate Settlement Procedures Act (RESPA) Section 8.

RESPA was enacted to prohibit brokers and lenders from unnecessarily augmenting a buyer's costs when negotiating a transaction involving the origination of a federally related loan on a one-to-four unit residential property. These augmented costs too frequently take the form of illegal *referral fees*; some don't since they are subject to competition.

Referral fees are paid by service providers, which include brokers, for referring business to them so they can perform a service in connection with a real estate purchase agreement or escrow to close a sale. These service providers, essential to the close of a sale, include title and finance companies, credit reporting agencies, home inspection and pest control companies, hazard insurers, escrow companies, and brokers.

The broker receiving a brokerage fee for negotiating the sale or purchase of a one-to-four residential unit which involves the origination of a loan may not receive a **referral fee in addition** to the brokerage fee on the sale as it would then be illegal. However, he can still profit from referring a buyer or seller to a service provider if he is an owner or co-owner of the service provider he recommended. Thus, the broker creates an **affiliated business arrangement**.

Profiting by referral to an affiliate

For the broker to meet conditions to profit from an **affiliated business arrangement**, he must:

- have an *ownership interest* greater than one percent in the business he's recommending to the buyer or seller; and
- hand a *written disclosure* of the affiliation to the person he refers to the controlled business. [See **first tuesday** Form 519]

The referral to an owned or co-owned service provider for profit is an affiliated business arrangement and is not subject to RESPA referral fee regulations. As an owner of the service provider, the benefit the broker receives from the referral is not the payment of a referral fee. Rather, the broker receives an indirect benefit from the referral through any annual profits generated for the co-owners by the operations of the service provider to whom he referred the business.

Thus, when the broker of a listed property refers the owner to a pest control business in which he holds an ownership interest, an affiliated business arrangement is created. If fully disclosed, the broker may benefit by sharing in any end-of-year profit the business realizes on the referral. Conversely, the broker who does not possess an ownership interest in the referred business is not involved in an affiliated business arrangement. Thus, the broker may not receive a referral fee and will receive no financial benefit from the referral.

An individual who accepts a referral fee or fails to disclose the existence of the affiliated relationship as prescribed by RESPA is subject to criminal penalties of $10,000, one year in jail, or both for each offense.

Also, the person referred to the service provider may in a civil suit receive up to three times the amount of the improper referral fee received by the broker, plus attorney fees. [12 United States Code §§2607(a), 2607(c)(4)(a), 2607(d)]

However, the broker referring a seller or buyer to a service provider he owns or co-owns must disclose his **ownership interest** in the provider to the seller or buyer on or before referring them to the provider. [24 Code of Federal Regulations §3500.15(b)(1); see **first tuesday** Form 519]

The disclosure includes the nature of the business relationship between the broker and the business providing the settlement services, as well as an estimate of the cost or range of costs to be charged. [24 CFR §3500.15(b)(1)]

Other disclosures for direct or indirect compensation exist and can be used in conjunction with the affiliated business arrangement. The Compensation Disclosure in a Real Estate Transaction form discloses the amount, its form, and the source of compensation and benefits the broker anticipates receiving for any service or from any party or provider as a result of their client's entry into a purchase agreement or other real estate transaction. [See Form 119 accompanying Chapter 8]

No additional service, no additional fee

A return on the ownership interest in a controlled business arrangement is not the only method a SFR broker can use to receive additional compensation in excess of his brokerage fee on the transaction. The broker may receive a second fee if he renders substantial loan origination services otherwise performed by the lender. However, this too is strictly regulated by RESPA.

RESPA established a **no-service**, **no-fee** restriction on real estate brokers and agents who are already acting on behalf of a buyer or seller in an SFR real estate transaction financed by a RESPA loan. A lender is prohibited from paying brokers and their agents a fee of any type when the broker is already receiving a fee on the sale for brokerage services they have rendered on behalf of a buyer or seller, unless the broker performs *significant services* on behalf of the lender. A second fee cannot be paid to the broker by anyone if it is received by the agent for acting only as a *referral agent*.

For example, the broker and his agent are entitled to a second fee in a sales transaction if they handle the loan escrow or process a loan application and loan documents, services which are significantly more involved than the act of a mere referral.

A lender or broker are in compliance with the no-service, no-fee rule if the earnings the broker is to receive for the **second service** were due the broker as:

- payment for **goods**; or
- payment for **services rendered**, other than the referral. [12 USC §2607(c)]

Before a broker and his agent who is to receive a brokerage fee on a sales transaction can accept another fee for an additional **second significant service**, such as a fee paid by a lender to the broker (or agent), the broker or the agent must perform numerous loan origination activities normally performed by the lender. Further, if sufficient loan origination activities are performed by the broker or his agent, then the second fee for loan related services must be justified as a dollar amount others would be paid to competitively perform the same services for the lender.

Duplicate charges for services

Real estate sales transactions are increasingly subject to **duplicate charges** imposed on both buyers and sellers by brokers, lenders, escrow agencies, and title companies during periods of rising property values. Duplicate charges for integral services, called *kickbacks* or *hidden costs* based on who ultimately receives them, are redundant and constantly experienced by the buying and selling public.

Public policy and sound economics suggest that duplicate charges are improper and make the real estate market more inefficient. They usually result from the systematic elimination of more competent and less costly competition. **Kickbacks** to listing and selling brokers (and builders), which are a violation of RESPA, are openly undertaken by some mortgage banks and title companies in an illegal effort to garner a larger share of the available business.

Kickbacks are a **corrupting business policy**. Legitimate operators find it difficult to compete with fraud without also stooping to the same fraudulent actions to meet the corrupt competition. Kickbacks, in the form of referral fees or other indirect financial benefits used to steer or capture business, interfere with the availability of lower rates and fewer charges. The buyer is referred to the lender (or title company) providing the kickback and away from the legitimate competition who will not take part in the consumer fraud.

California legislation does not, but should, prohibit referral fees from lenders or anyone else who renders services as a third-party in a real estate related transaction in which a broker is collecting a fee for acting on behalf of a principal.

Real estate agents who are employed by a broker (which they must be to act as a licensee) face a similar prohibition in real estate transactions. Agents acting under their licenses are prohibited from accepting a fee or other benefit from any person other than their employing broker, or from themselves paying a fee to any other broker or agent without first directing the payment through their employing broker. [Calif. Business and Professions Code §10137]

Chapter 7 — Finders: a nonlicensee referral service

This chapter addresses a broker's or his agent's use of finders to provide them with leads to sellers, buyers, or borrowers under California and federal law.

Agency relationships in real estate transactions

Three classes of **real estate agents** have been established in California:

- *licensed* brokers;
- *licensed* sales agents; and
- *unlicensed* finders.

Licensed brokers and **sales agents** owe *fiduciary duties* to the principals they represent. **Fiduciary duties** require licensees to perform on behalf of their client with the utmost care and diligence.

An **unlicensed finder** has no such fiduciary duty. A finder's function as an "agent" is limited to soliciting, identifying, and referring potential real estate clients or participants to brokers, agents, or principals in exchange for the promise of a fee.

A finder working for a principal is distinguished from a licensed broker working for a principal. Limitations are placed on the **conduct of a finder**. A finder lacks legal authority to participate in any aspect of property information dissemination or other transactional negotiations. [Calif. Business and Professions Code §§10130 et seq.]

Although not licensed by the California Department of Real Estate (DRE) or admitted as members of a real estate trade association, finders are authorized by California statute *to solicit* prospective buyers, sellers, borrowers, lenders, tenants, or landlords *for referral* to real estate licensees or principals. Thus, they **provide leads** about individuals who may become participants in real estate transactions.

Soliciting to place or refer a match

A finder providing referral services in California for a fee may:

- find and *introduce parties*;
- *solicit parties* for referral to others [**Tyrone** v. **Kelley** (1973) 9 C3d 1]; and
- be *employed* by principals or brokers.

A finder may not:

- take part in any negotiations [Bus & P C §10131(a)];
- discuss the price;
- discuss the property; or
- discuss the terms or conditions of the transaction. [**Spielberg** v. **Granz** (1960) 185 CA2d 283]

A finder who crosses into any aspect of negotiation which leads to the creation of a real estate transaction needs a real estate license as he is both **soliciting and negotiating**. Unless licensed, an individual who enters into negotiations (supplying property or sales information) cannot collect a fee for services

rendered — even if he calls it a finder's fee. Also, he is subject to a penalty of up to $20,000 and/or a six-month jail term for engaging in brokerage activities without a license. [Bus & P C §§10137, 10139]

In addition, a broker who permits a finder or anyone else in his *employ* (or his agents' employ) to perform any type of "licensed" work beyond solicitation for a referral, may have his license suspended or revoked. [Bus & P C §§10131, 10137]

RESPA limits authority to split fees

The Real Estate Settlement Procedures Act (RESPA) prohibits brokers, with two major exceptions, from giving or accepting a referral fee if the broker or his agent is acting as a *transaction agent* in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related loan. [24 United States Code §2607(a); 24 Code of Federal Regulations §3500.14(b)]

Thus, a broker and his agents are not involved in a RESPA transaction when negotiating the sale, lease, or encumbrance of any of the following types of properties:

- apartment buildings with five or more units;
- commercial buildings;
- agricultural properties;
- business opportunities;
- vacant land (other than those involving one-to-four unit residential construction loans);
- properties containing 25 or more acres;
- leases and rental agreements;
- all-cash transactions; and
- seller carryback transactions where no federally-related loan is originated. [12 USC §2606(a)(1); 24 CFR §3500.5(b)(1)]

Business development and RESPA

A broker and his agents need to develop methods for **generating business**. If not, their *business model* will not produce sufficient numbers of clientele to provide enough earnings to keep them from being driven out of the real estate brokerage profession.

Many methods for finding and soliciting clientele exist. The source of clients most often discussed, and cherished, is the **referral**. In fact, agents not employed by media/franchise brokers are said to live by referrals alone.

Also, brokers cooperate among themselves, as in agent-to-agent referrals between different segments of the brokerage community, such as the referral of a homebuyer by a property manager to an MLS sales agent and vice versa with a prospective tenant.

Brokers and agents in single family residence (SFR) sales rarely develop a client base of homebuyers sufficiently large enough to sustain a decent standard of living from sales fees generated by transactions handled on behalf of these homebuyer clients. Thus, a **business model** for finding and locating clients on a regular basis must include sources other than clients personally located, i.e., found by the broker.

Many methods exist to generate new clients. Advertising through printed and electronic/digital media to solicit clients is fundamental and universally understood and expected by all. Media advertising is a **general blast** at members of the public in an effort to locate those few among them who, at that moment, need the services of a real estate agent.

On the other hand, finding and locating a client becomes a more focused and arduous task when a broker's business model expands beyond exclusive use of media, which develops name recognition for the broker/agents, into the time consuming task of **personally soliciting** clients. In a personal solicitation effort designed as an additional method for generating clientele, the agent places himself and those he induces to act on his (specifically, his broker's) behalf, directly between the prospective client and the employing broker, e.g., when:

- the employing broker "refers" clients directly to his agent;
- an agent takes "floor time" to solicit new clients who call in response to media advertising and the "brand name" the broker has established;
- an agent canvasses a neighborhood or section of the community in a classic on-going *farming operation* to find and solicit new clientele (for his broker); or,
- an agent extends his reach to potential buyers and sellers of SFRs by inducing both licensed and unlicensed individuals to be "team members" who locate and solicit clientele for the agent (again, read that as for the broker), all being activities which comply with both RESPA and Department of Real Estate (DRE) regulations.

It is the employment of unlicensed *locators* of buyers and sellers to extend the reach of the agent to develop business which will bring his earnings to a level sufficient to sustain the standard of living the agent seeks. This is permissible. State and federal regulations addressing the **relationship** between the finder/locator and the broker/agent, and between the public and the finders/locators acting on behalf of the broker/agent, are straightforward and compliance is relatively easy.

All employees of a broker must be hired under **written contracts** of employment. Licensed agents are hired, administrative staff is hired, and finders are hired by brokers. Written contracts are entered into to delineate the responsibilities each has undertaken and to limit their conduct to that permitted by regulations for their different licensed or unlicensed status.

These employments, the finder included, are not casual relationships which the broker/agent develops over time with friends, neighbors, past clientele, or social contacts, a word-of-mouth network of "viral adverts" generating referrals for which no fee is paid. Employed individuals **generate business** for the broker/agent, the finder being limited by the nature of his employment to locating and soliciting new clientele for the broker/agent.

Fee sharing by a broker under RESPA

RESPA, like a title insurance policy, initially sets out a blanket rule as the starting point for arriving at the final conditions. RESPA's initial statement is that no **referral fee** can be *paid or received* by a settlement service **provider** (broker/escrow/lender) who will be rendering transactional services in exchange for compensation in a RESPA sale (mortgage financing on a one-to-four unit residential sale).

Likewise, a title insurance policy's initial statement proclaims no encumbrance of any type exists on the title being insured. The policy provisions then proceed to list exclusions, exceptions, and conditions which nearly neuter the initial general statement.

Here too, as with all initial statements and generalities, RESPA provides several *exceptions* allowing fee sharing. These exceptions permit the broker to conduct orderly **business development** which does not violate the RESPA principle of avoiding double dipping (referrals among providers) or surcharges. RESPA's goal is to prohibit activity which artificially drives up the cost buyers and sellers pay for services needed to close a sale such as occurs with duplicate fees charged for services implicitly covered by the provider's basic fee.

Two **RESPA exceptions** go to the heart of sourcing new clientele and sharing fees:

- referral fees paid to or received from other brokers, a *horizontal disbursement* from one broker to another, other than by loan brokers or lenders who are or will be involved in a resulting RESPA transaction [24 CFR §3500.14(g)(1)(v)]; and
- fees paid by the broker to the broker-employed licensed sales agents or **unlicensed finders**, a *vertical disbursement* within the broker's office, not paid to providers or third parties connected or to be connected to a resulting RESPA transaction. [24 CFR §3500.14(g)(1)(vii)]

While both of these exceptions to RESPA permit payment of fees under federal law, DRE regulations under California law **limit the conduct** of these individuals when actually rendering services permitted by RESPA.

While the RESPA exceptions allow *fee-splitting* activity, the DRE regulations require the **fee splitting** to be limited exclusively to:

- payments between brokers (who then may split the fee with their agents); or
- payments between a broker and the agents he employs, licensed or unlicensed.

While RESPA allows agents and finders who are employed by a broker to receive fees for **generating business**, the DRE regulations (and statutory/case law) set forth the *limits of conduct* each type of employee of the broker may undertake with the clientele.

To **satisfy RESPA**, the employment of a finder must be under an agreement where the employee-finder is obligated to bring to the broker's attention **every prospect** located of the sort the broker is looking for. The employee-finder's sole purpose is to generate business for his broker and does not have the freedom, by contract, to refer a prospect to just any broker. [24 CFR §§3500.2(b), 3500 Appendix B, examples 11 and 12; **Zalk** v. **General Exploration Co.** (1980) 105 CA3d 786; see Form 115 accompanying this chapter]

Three classes of finders exist under RESPA:

- **friends or past customers** who pass on tips to brokers and/or sales agents;
- **individuals** who sell "lead lists" to brokers; and
- **bona fide employees** of brokers who generate business for their employing broker, classified as *financial services representatives* (FSRs). [24 CFR §3500 Appendix B, example 12]

Entitlement to a fee under RESPA

Finders are also entitled to a fee for referrals under RESPA, dependent upon the type of finder they are and whether RESPA controls.

A friend or past customer type of unlicensed finder who is not under contract and therefore not employed by a broker would not be entitled to a finder's fee if the broker to whom a new client was referred provided settlement services on a RESPA-controlled transaction. If RESPA did not control, this type of finder would be entitled to a fee under California law.

A *bona fide employee*, such as a FSR, of a broker is not barred from collecting a fee or salary from his employer-broker since employed individuals are exceptions to RESPA.

A person who sells lead lists are also able to legally collect a fee under both RESPA and non-RESPA transactions. Lead lists are considered "goods" and are perfectly legal in California, as well as under the

FINDER'S FEE AGREEMENT

NOTE: This form is used by brokers and their agents to employ an unlicensed individual to locate, solicit and refer or identify persons who need the services of the broker and his agents. [Calif. Business and Professions Code §§10130, 10139]

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

1. In consideration for services to be rendered by Finder, Broker hereby contracts with Finder to refer to Broker a prospective client in need of services as a:

☐ Buyer ☐ Lender ☐ Borrower
☐ Owner/Seller ☐ Tenant ☐ Landlord

2. Finder agrees not to participate in or conduct any negotiations with the prospective client or solicit loans on behalf of the prospective client.

2.1 Finder is not licensed by the California Department of Real Estate.

3. The prospective client is identified as:
Name ____
Address ____
Telephone ____

3.1 Further referrals of other prospective clients may be included in this agreement by an addendum signed by both Broker and Finder. [See **ft** Form 250]

4. The real estate involved, if any, is referred to as
Common address ____
Legal description/Assessor's parcel number _______________________________
____
____

5. As compensation for each referral by Finder, Broker agrees to pay Finder the following amount:

a. $_______________ for each prospective client.

b. ______% of Broker's fee received on the first transaction with each prospective client.

c. ______% of the purchase price paid on the first transaction with each prospective client on which Broker receives a fee.

d. Other:____

6. Finder's compensation is earned and payable:

a. ☐ On close of the first transaction involving each prospective client.

b. Other time of payment____

c. Should the prospective client not enter into a commissionable transaction through Broker within ______ months after the date that prospective client is identified in writing to Broker, Broker shall owe Finder no compensation.

7. Additional terms and conditions: _____________________________________
____
____.

I agree to the terms stated above.
Date:_____________, 20______
Broker:____________________________________
By:____
Address: ___________________________________
____
Phone:_____________________________________
Fax: _______________________________________
Email: _____________________________________

I agree to the terms stated above.
Date:_____________, 20______
Finder's name: ______________________________
Signature: __________________________________
Social Security #: ____________________________
Address: ___________________________________
____
Phone:_____________________________________
Fax: _______________________________________
Email: _____________________________________

FORM 115 02-09

RESPA exception for goods actually furnished. [24 CFR §3500.14(g)(1)(iv); see DRE Real Estate Bulletin, Spring 2006]

Referral fees to other fiduciaries prohibited

Anyone can be a paid finder, unless barred by professional regulations or code-of-ethics or conflict-of-interest policies controlling an individual's conduct.

For instance, a licensed agent registered with the DRE as an employee of a broker cannot be a finder. The agent is employed to solicit clients on behalf of his broker, not others. In turn, only his broker can receive a fee generated by the agent's real estate licensed activities. On the employing broker's receipt of a fee, the fee is split with the agent under their written employment agreement. [Bus & P C §10132; Department of Real Estate Regulations §2726]

Certified public accountants (CPAs) are barred by regulation from being paid as finders and receiving a fee for the referral of their clients to others. [16 Calif. Code of Regulations §56]

A finder who advertises to locate leads he will place or refer to a broker or principal must not hold himself out as also rendering services which require a broker's license. [Bus & P C §10139]

Thus, a finder may advertise as a "referral service." He may state he will **place** an interested party with a broker or principal, or **refer** a principal to a match sought for a real estate transaction.

The finder's fee bargain

Generally, a **finder's fee** is a lump sum amount or a percentage of the fee received by the broker on a transaction which is closed due to the finder's referral. Only sound economics controls the amount of the fee a broker, agent, or principal should pay a finder for a lead. Also, no limit is placed on the volume of referral business conducted by a finder.

For instance, a broker can compensate his finder with:

- a salary;
- a percentage fee; or
- a lump sum basis per closing. [Zalk, *supra*]

Also, while brokers may, finders may not collect advance fees from principals. **Advance-fee operators**, masking themselves as finders for principals, sometimes collect fees "up front," a prohibited activity for an unlicensed individual. [Bus & P C §10131.2]

Entitlement to a fee under California law

A finder is entitled to a fee as an unlicensed individual if he solicits, locates, places, introduces, or delivers up names of prospective clients to a broker or principal. [Tyrone, *supra*]

A finder's fee agreement entered into between a **finder and a principal** regarding the finder's referral services must be *evidenced in a writing* signed by the principal who employed the finder. If not, the finder cannot enforce his fee agreement with the principal. [Calif. Civil Code §1624(a)(4)]

However, the principal's **use and benefit** of a finder's referral under an oral finder's fee agreement, such as closing a sale with an individual referred by the finder, will substitute for a written agreement. [**Tenzer** v. **Superscope, Inc.** (1985) 39 C3d 18]

Conversely, oral fee agreements between a **broker** (or his agents) **and a finder** are enforceable. No written agreement is required between a broker (or his agents) and a finder. However, a writing memorializes the agreement as documentation against memories to the contrary, and in conformance with DRE regulations. [See **first tuesday** Form 115]

Consider a nonlicensed individual who enters into an oral agreement with a broker to introduce the broker to prospective buyers or sellers in return for 10% of the broker's earnings on any transaction put together with the "lead."

The finder introduces the broker to prospects who close transactions with the broker. The broker refuses to pay the finder the agreed-to compensation since the oral agreement is not evidenced in a writing signed by the broker who retained him.

However, the finder can enforce the broker's oral fee agreement. Oral fee-sharing agreements between brokers or finders are enforceable. [**Grant** v. **Marinell** (1980) 112 CA3d 617]

Chapter 8 Due diligence obligations

This chapter focuses on the due diligent conduct owed a seller or buyer on the exclusive employment of a broker and his sales agents.

The duty owed to clients

Every exclusive listing agreement entered into by an agent on behalf of his broker is an employment which creates a client relationship. The employment imposes **special agency (fiduciary) duties** on the broker and the agent, owed to the client, to use *due diligence* in a continuous effort to meet the objective of the employment, be it to buy, sell, lease or finance an interest in real estate. [See **first tuesday** Form 102 §1.2]

The promise of **due diligence** is the consideration a broker and his agents give their client to render services in exchange for employment as the *exclusive representative* of the client to locate the "match" sought by the client. If the promise to use diligence in the employment is not stated in the exclusive listing agreement, it is *implied* as existing in the relationship.

The broker with authority to be the exclusive representative of a client must take reasonable steps to promptly gather all *material facts* about the property in question which are *readily available* to the broker or the broker's agent. After gathering factual information about the integrity of the property, the broker's agent proceeds to do every reasonable and ethical thing to pursue, with utmost care, the purpose of the employment.

In contrast to an exclusive listing, a broker and his agents entering into an **open listing** are not committed to render any services at all. The broker and his agents only have a *best-effort obligation* to act on the employment.

However, when an agent holding an open listing enters into preliminary negotiations, such as an exchange of property data, a due diligence obligation arises to provide the utmost care and protection of the client's best interests. Having **acted on the open listing**, the agent must now inspect the property and gather all readily available information on the property under consideration.

Once the agent actually begins to perform services under an open listing entered into by a buyer or seller, the agent has **acted on the employment** and the due diligence standards of duty owed to the client apply to his future conduct.

The listing broker becomes the buyer

Consider an agent employed under a listing agreement to locate a buyer for the listed property.

The agent prepares a purchase agreement naming himself as the buyer and submits it to the seller. The agent states the price offered is the fair market value of the property. Based on this representation, the seller agrees and enters into the purchase agreement.

Prior to the close of escrow on his purchase, and still within the listing period, the agent locates a buyer who agrees to pay the agent for an assignment of the agent's right to buy the property under the purchase agreement entered into with the seller. The amount paid to the agent for the assignment is equal to 10% of the price stated in the purchase agreement.

When the agent asks the seller to consent to the assignment and substitution of a new buyer under the purchase agreement and escrow instructions, the agent tells the seller the buyer is buying the property for no more than the purchase price stated in the purchase agreement. The seller, based on the agent's representation of the amount paid for the property by the substituted buyer, agrees to the assignment of the agent's right to buy the property.

After escrow closes, the seller discovers the buyer paid the agent a higher purchase price in the form of an *assignment* fee on top of the price agreed to in the purchase agreement between the agent and seller.

The seller makes a demand on the agent for the assignment fee, as an undisclosed secret profit, and for a return of the commission paid. The seller claims the agent breached his fiduciary duty since the agent failed to disclose the profit he received as a result of his employment under the listing agreement, depriving the seller of his ability to sell his property for its highest possible value.

The agent claims he had no duty to disclose the profit taken for the assignment since his status under the purchase agreement was as a principal with an interest in the property he could sell.

Does the agent have a duty arising out of the listing agreement to disclose to the seller the profit taken on the assignment of the agent's right to buy the listed property?

Yes! The **agency relationship** created by the listing agreement was *not extinguished* by the purchase agreement entered into by the seller and the agent as the buyer. The agent owed the seller a duty upon entering into a listing agreement to get the seller the highest possible price for the property and to disclose any and all compensation or profit made as a result of becoming the seller's agent.

The agent, due to the listing, owes the seller all of his benefits received on the transaction, including the assignment fee and the brokerage fee he received. Further, the Department of Real Estate (DRE) Commissioner may revoke his license for taking compensation which was not disclosed. [**Roberts** v. **Lomanto** (2003) 112 CA4th 1553; Calif. Business and Professions Code §10176(g); see **first tuesday** Form 401-2; see Form 119 accompanying this chapter]

Diligence includes the advice and counsel the agent gives the client about the property, the market pressures, impending negotiations and their consequences which affect the client's position.

Maintaining the client file

Typically, the agent who produces a listing (and thus his broker's right to a fee) becomes the agent in the broker's office who is responsible to the broker for the care and maintenance of the client's file.

On entering into a listing, a **physical file** must be set up to house information and document all the activity which arises within the broker's office due to the existence of the listing. For example, the file on a property listing should at least contain the original listing agreement, its addenda and all the property disclosure documents the seller and listing agent provide to a prospective buyer before the seller accepts an offer to buy.

The file needs an **activity sheet** for entry of information on all manner of file activity. Any paperwork, notes, messages, billings, correspondence, email printouts, fax transmissions, disclosure sheets, worksheets, advertising copy, tear sheets, copies of offers/counteroffers and rejections, and all other related documentation are to be kept in the file. Nothing occurs as a result of the client employment which is not to be put in and retained in the file.

COMPENSATION DISCLOSURE IN A REAL ESTATE TRANSACTION

(California Business and Professions Code §10176(g), DRE Reg. 2904)

NOTE: A Broker and his agents, when negotiating a real estate transaction, are mandated to disclose to the party they represent (client) the form, total amount, and source of all compensation and economic benefits they anticipate receiving for any service or from any person or provider as a result of their client's entry into a real estate related transaction. This form is used to disclose compensation not disclosed in other documentation held by the client.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:
☐ Purchase Agreement ☐ Exchange Agreement
☐ Escrow Instructions ☐ ______________________

1.1 ☐ of the same date, or dated _____________, 20______, at ___________________________, California,

1.2 entered into by ____, as the Buyer, and

1.3 ____, as the Seller,

1.4 regarding real estate referred to as ____.

2. The client represented by the undersigned Broker with regards to the above referenced agreement is the ☐ Buyer, ☐ Seller, or ☐ both Buyer and Seller.

DISCLOSURE OF COMPENSATION:

3. Broker provides the following information as a disclosure to the client of all compensation and economic benefits to be received as a direct or indirect result of the client's entry into the above referenced agreement and not previously disclosed by Broker and his agents.

Source of compensation (Seller, Lender, etc.)	Form (cash, membership, etc.)	Amount (dollar values)
3.1		$_______________
3.2		$_______________
3.3		$_______________
3.4		$_______________

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for controlled business arrangements and conflicts of interest. [See **ft** Forms 519 and 527]

BROKER:

5. I certify that the above information is true and correct and represents all compensation not previously disclosed that Broker and his agents anticipate receiving in the above referenced transaction.

Date: _____________, 20______

Broker's Name: ____

By: ____

Name: ______________________ Title: ______________________

CLIENT: I have received a copy of this disclosure. ☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____________, 20______

Name: ____ Name: ____

Signature: ____________________________________ Signature: ____________________________________

If the source of the compensation is connected to the origination of a loan in the above referenced agreement, the other party to the agreement must also acknowledge receipt of a copy of this disclosure.

PARTY other than client: I have received a copy of this disclosure.

Date: _____________, 20______

Name: ____ Name: ____

Signature: ____________________________________ Signature: ____________________________________

FORM 119 12-08

The file is the **broker's file**, not the listing agent's file, although it will likely remain with the listing agent until close of a sale on the listed property or the listing expires unrenewed. The agent hands the broker the completed file on close of escrow, usually a *condition precedent* to payment of the agent's share of the fee received by the broker.

Guidelines and checklists

Guidelines used to build a file's content are available in the many forms, such as checklists prepared by a broker or his listing coordinator, a transaction coordinator's (TC's) closing checklist, escrow worksheets, work authorization forms, advance fee and advance cost checklists, or income property analysis forms. [See **first tuesday** Form 403]

Checklists belong in the file to be reviewed periodically by the agent, office manager, TC or employing broker for work which can be done to better service the listing and earn a fee.

This chapter discusses some — but certainly not all — steps a broker and his agent might undertake to fulfill their employment responsibilities owed to the client. They include:

1. A **property profile** of the seller's title from a title company in order to identify all owners needed to list, sell and convey the property.
2. A **condition of property** disclosure sheet (Transfer Disclosure Statement) filled out and signed by the seller. [See **first tuesday** Form 304]
3. A **home inspection report** (by a home inspector) paid for by the seller and attached to the condition of property statement (TDS) before the listing agent signs the TDS.
4. A **natural hazard disclosure** (NHD) on the property from a local agency or a vendor of NHD reports, paid for by the seller, and reviewed and signed by the seller and the listing agent. [See Form 314 accompanying Chapter 14]
5. An **annual property operating disclosure** (APOD) statement covering the expenses of ownership and any income produced by the property, filled out and signed by the seller, together with a rent roll and copies of lease forms which the owner uses, to be included in the listing package only after reviewing the seller's data. [See **first tuesday** Form 562 and Form 352 accompanying Chapter 22]
6. Copies of all the Covenants, Conditions and Restrictions (CC&Rs), disclosures and assessment data from any **homeowners' association** involved with the property. [See **first tuesday** Form 150 §11.9]
7. A **termite report** and clearance paid for by the seller.
8. Any replacement or **repair of defects** noted in the home inspection report or on the TDS, as authorized and paid for by the seller.
9. An occupancy **transfer certificate** (including permits or the completion of retrofitting required by local ordinances) paid for by the seller.
10. A statement on the amount and payment schedule for any special district property **improvement bonds** which are liens on the property (shown on the title company's property profile).
11. A **visual inspection** of the property and a survey of the surrounding neighborhood by the listing agent to become informed about readily available facts affecting the marketability of the property.
12. **Advising** the seller about the marketability of the listed property based on differing prices and terms for payment of the price, and for property other than one-to- four residential units, the financial and tax consequences of various sales arrangements which are available by using alternative purchase agreements, options to buy, exchange agreements and installment sales.
13. A **marketing (listing) package** on the property compiled by the listing agent and handed to prospective buyers or buyer's agents before the seller accepts any offer to purchase the property, con-

sisting of copies of all the property disclosures required to be handed to prospective buyers or the buyer's agent by the seller and listing broker.

14. A **marketing plan** prepared by the listing agent and reviewed with the seller for locating prospective buyers, such as by distributing flyers, disseminating property data in multiple listing services, newspapers and periodicals, broadcasts at trade meetings attended by buyer's agents, press releases to radio or television, internet sites, posting "For Sale" signs on the premises, hosting open house events, posting on bulletin boards, mailing to neighbors and using all other advertising media available to reach prospective buyers.
15. A **seller's net sheet** prepared by the listing agent and reviewed with the seller each time pricing of the property is an issue, such as when obtaining a listing, changing the listed price, reviewing the terms of a purchase offer or when substantial changes occur in charges or deductions affecting the net proceeds from a sale since the net sheet discloses the **financial consequences** of the seller's acceptance of a purchase agreement offer. [See Form 310 accompanying Chapter 23]
16. Informing the client of the listing agent's **sales activities** by weekly communications advising what specifically has been done during the past several days and what the listing agent expects to do in the following days, as well as what the seller can do in response to comments taken by the listing agent from buyers and their agents, and to changes in the real estate market.
17. Keeping records in a client file of all activities and documents generated due to the listing.

Duty to DRE to keep records

All records of an **agent's activities** on behalf of a buyer or seller during the listing period must be retained by the agent's broker for three years. [Bus & P C §10148]

The **three-year period** for retaining the buyer's or seller's activity file for Department of Real Estate (DRE) review begins to run from the closing date of a sale or, if a sale does not occur, from the date of the listing.

The records must be available for inspection by the Commissioner of Real Estate or his representative, or for an audit the Commissioner may order.

Advising the seller

An agent, on behalf of his broker, solicits an owner of a run-down (depreciated) single-family residence to list the property for sale.

After gathering and analyzing data on comparable sales, the agent advises the seller that the present condition of the property justifies a listing price of no more than $230,000.

However, the agent believes the property will sell for $300,000, an additional $70,000 in price, if the seller is willing to spend $15,000 to $20,000 to correct deferred maintenance and eliminate some obsolescence.

Also, the agent is aware the current demand by buyers of a residence in this price range consists mostly of individuals who are looking for a ready-to-occupy home, with few speculators looking for "fixer-uppers" they can restore and resell at a profit.

The agent determines the seller has the funds needed to correct the defects and appearance of the property. Based on market demands and housing prices, the agent advises the seller to invest the time, effort and money to fix up the property. However, the seller is not now willing to invest funds to fix up the property.

Rejecting the agent's advice, the seller agrees to list the property for sale at $230,000 and sell it in its present condition, after full disclosure of the property's condition by including a home inspection report.

Since the client has rejected the agent's advice, does the agent now need to explain the reasoning behind his advice?

Yes! Professionals are liable for their failure to explain the **rationale** behind their advice and the **consequences** which can result when advice is rejected. Here, the agent needs to advise the seller (and confirm in a memo) that the resale value of the property after the property has been fixed up for sale will increase. So, when it is fixed up by a buyer and resold at a far greater price, the broker and his agent have evidence they advised the client about the consequences (costs) of this inaction. [**Truman** v. **Thomas** (1980) 27 C3d 285]

Advice and consequences

In a real estate transaction, brokers and their agents must be certain who is their **client**. Likewise, they must determine who is not their client, but is a **customer** with whom the broker is directly negotiating or who is represented by another broker. Only a general duty to deal fairly and honestly is owed to a customer.

For example, the *general duty* owed a perspective buyer by a listing agent regarding property disclosures does not include advice on what investigations, audits or additional reports on the disclosed defects are available, or what reasons the agent may have to believe they should be obtained by a prudent buyer.

Further, a listing agent does not owe a duty to the prospective buyer to explain the consequences of the customer's **failure to further investigate** or analyze adverse facts disclosed by the agent. Investigations and inquiries are the **customer's duty of care** owed to himself to exercise concern for the protection of his own interests.

Also confusing for customers is the purpose behind the brokerage community's use of pre-printed suggestions, recommendations, and disclaimers of responsibilities, few of which are relevant to any one transaction. They are typically handed to each person in a sales transaction by the listing agent with a demand the parties acknowledge receipt of the preprinted, boilerplate and mostly irrelevant advice, called *advisory disclaimers*.

When a listing agent hands these advisory disclaimers to a third-party customer, such as a prospective buyer, the advisory provides a disclosure of the services available to the customer (by other than the listing agent). The advisory disclaimers **recommend** that the buyer independently check out and determine the consequences of the property information disclosed by the listing agent and undertake efforts to protect his interests in the transaction (whether or not he has retained a broker to do so).

Advising the buyer

However, a buyer is entitled to far more assistance from his agent than the naked suggestions or recommendations contained in **advisory disclosures** about the availability of services. The duty of the buyer's selling agent goes well beyond the listing agent's limited disclosure obligations.

If these boilerplate advisory services were contracted for, the buyer would be provided with an independent analysis of the property and the transaction.

Here, the buyer's broker and his agent, acting on behalf of a buyer, must use the advisory statement of recommended investigations as a **checklist** of activities from which the buyer's agent will select those services he believes his buyer should undertake to protect the buyer's interests.

More importantly, services the buyer's agent has **reason to believe** the buyer should engage must be made the subject of *contingency provisions* in the purchase offer. Thus, the buyer's agent allows the buyer (and

himself) an opportunity and the time needed to investigate and analyze the agent's concerns prior to closing.

For example, a buyer's agent has an affirmative duty of care to protect his buyer by pointing out why a recommended activity or inquiry needs to be undertaken in a transaction when the activity may uncover a situation which, if it exists, must be dealt with prior to closing. If it were otherwise, the conditions suspected by the buyer's agent to exist would interfere with the buyer's use and successful ownership of the property after closing.

A residential broker and his agents nearly always know more about one-to-four unit residential property conditions and the transactional aspects (legal, financial and tax) which will affect the client than the client does. With this knowledge of facts and inclinations about the property, the parties, available services, the documents involved and the provisions they contain, agents have insight into the need for a particular investigative report. The reports would address problems the agent suspects might exist which would have an adverse impact on the client's sale or use of the property.

The buyer's agent using an advisory statement of recommended activities as a checklist will:

- determine which of the itemized activities his buyer should undertake before closing;
- help the buyer weigh the probability of discovering undisclosed defects or conditions which would have consequences adverse to the buyer's objectives; and
- help the buyer analyze the risk of loss should defects of the type suspected be discovered after closing.

Chapter 9 — The listing agent and the prospective buyer

This chapter distinguishes a listing agent's limited, nonfiduciary general duty owed to all prospective buyers from a buyer's agent's special fiduciary agency duties owed to these buyers.

General duty to voluntarily disclose

A listing broker and his agents have a *special fiduciary agency duty*, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property on the listed terms.

On locating a prospective buyer, either directly or through a buyer's agent, the listing agent owes the prospective buyer, and thus also the buyer's agent, a limited, nonclient *general duty* to **voluntarily provide information** on the listed property, called *disclosures*. What is limited about the duty is not the extent or detail to which the listing agent may go to provide information, but the **minimal quantity** of fundamental information and data about the listed property which must be handed to the prospective buyer or the buyer's agent.

The information disclosed need only be sufficient enough in its content to place the buyer on notice of facts which may have an **adverse affect** on the property's value.

Thus, the disclosure obligations of the listing agent to voluntarily inform prospective buyers about the fundamentals of the listed property acts to limit the listing agent's ability to employ any conduct or means at hand to exploit the prospective buyer. The listing agent may not:

- deliver up less than the minimum level of information to put the buyer on notice of the property's fundamentals;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property while in the vigorous pursuit of the best financial advantage obtainable for the seller.

Gathering facts on adverse features

The gist of a listing agent's limited general duty owed to a nonclient prospective buyer is to put the prospective buyer or the buyer's agent on notice of facts which might, if known to the prospect, **adversely affect his valuation** of the listed property.

The methods for gathering adverse facts about the property's **fundamental characteristics**, as well as those facts which enhance value, which the listing agent is specifically required to use on a one-to-four unit residential property include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property and entering any observations on the seller's Condition of Property (Transfer) Disclosure Statement (TDS) if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been or will be obtained by the seller [Calif. Civil Code §2079];

- assuring **seller compliance** with the seller's duty to deliver statements to prospective buyers as soon as practicable, i.e., disclosing a variety of facts about natural hazards (NHD), the condition of the property (TDS), the local environment (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, condo documents, etc., **by providing the seller** with statutory forms at the listing stage to be filled out by the seller, and picking up the seller prepared and signed documents for inclusion in the marketing/listing package to be handed to prospective buyers;
- **reviewing and confirming**, without further investigation or verification by the listing agent, that all the information and data in the disclosure documents received from the seller are consistent with the listing agent's knowledge about the information and data, and if not, correct the information and data, or if the listing agent has reason to believe the information might not be accurate, either investigate and clarify the information or disclose his uncertainty about the information to the seller and the prospective buyer;
- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to **reduce the exposure** to claims by a buyer who might discover deficiencies in the property not known to the seller or the listing agent or, worse yet, were known and not disclosed prior to entry into a purchase agreement, and then make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and
- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to be or which might be considered detrimental to the value of the property without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a *material fact* about which the prospective buyer needs more information before completing negotiations or acquiring the property.

The pass-through of filtered information

A listing agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to his prior knowledge about the property and the observations he made while conducting his **mandatory visual inspection**. To complete the disclosure process, the listing agent serves as a conduit through which property information provided by the seller is filtered before it is passed on to the prospective buyer.

Accordingly, all property information received from the seller must be reviewed by the listing agent for any inaccuracies or untruthful statements **known or suspected to exist** by the listing agent. Corrections or contrary statements by the listing agent must be included before the information may be used to market the property and induce prospective buyers to purchase.

The extent to which disclosures about the physical condition of the property must be made is best demonstrated by what the listing agent is **not obligated** to provide.

Of concern to buyer's agents is the fact listing agents have **no duty to investigate** any of the information or data provided by the seller in an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, before handing a prospective buyer information received from the seller, the listing agent must:

- **review the information** received from the seller;

- **include comments** about the agent's actual knowledge and observations he made during his visual inspection of the property which reflect the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- **identify the source** of the information as the seller.

The dumb agent rule

A listing agent on a one-to-four unit residential property **owes no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any facts about:

- the property's **title conditions**, consisting of encumbrances which a preliminary title report would disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello Roos bonds;
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller must make about any fire hazard clearance requirements which exist due to the property's location (NHD);
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning, which affects the property, and nearby ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** to meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the listing agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the listing agent.

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the listing agent is duty-bound to respond fully and fairly to the inquiry. The response must include material facts known to the listing agent about the subject matter of the inquiry and be free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent on his behalf who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the listing agent, must determine what due diligence efforts are first required before allowing the buyer to make the decision to purchase or close escrow.

Opinions in lieu of investigations

Consider a listing agent of a residence who is asked by a prospective buyer to point out the location of the boundaries for the lot on which the home is located. The agent does not provide the buyer with the metes and bounds description contained in subdivision maps or tell the buyer to investigate the location

of the boundaries himself. Instead, the agent says the boundaries are represented by a fence which surrounds the property.

The agent does not indicate the source of this opinion, such as the seller, a surveyor or himself. He also does not conditionalize his statement with words such as “the boundaries in this subdivision are usually where the fence has been placed.” The agent did not even say, “in my opinion” or “I believe” to state any uncertainty he may have about the location of the boundaries. His statement of the boundary location was absolute — it is the fence.

The buyer further indicates he intends to have a pool built for the use of his family if he acquires the property. The listing agent does not respond to the buyer’s statement about the intent to build a pool. The agent has no actual knowledge of easements or zoning ordinances which could **adversely affect** implementation of the buyer’s intended future use of the property.

Further, the buyer asks the seller to confirm whether the fences are the outside parameters of the property. The seller indicates the fences demarcate the division line between the properties.

Without further investigation, a purchase agreement is entered into by both the prospective buyer and the seller. In preparation of the purchase agreement offer, the agent does not include a contingency provision to provide the buyer with an opportunity to verify the location of the boundaries or to confirm his ability to obtain a permit to build a pool as a condition for closing escrow.

Prior to closing, the title company is not asked nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor was consulted about the ability to obtain a permit to build a pool.

The actual facts place the location of the rear fence several feet beyond the property line, giving the rear yard the actual appearance of having sufficient room to accommodate a pool, which it will not. Also, an easement for water lines and a sewer line runs across the entire rear of the property, as well as along one side of the home allowing these services to be supplied to a rear, uphill property.

Here, the buyer acted in reliance on the agent’s (and seller’s) opinion about the location of the boundaries to close escrow. As a result, liability for the boundary discrepancy will be imposed on the agent for his failure to **conditionalize his statement** about the location of the boundaries. Without qualifying his statement, the agent misrepresented the actual location of the boundaries.

Further, the agent, due to his lack of actual knowledge of the easements, has no liability exposure for his failure to disclose the easements which further interfered with meeting the announced interest of the buyer to build a pool. The listing agent did not owe the buyer a duty to advise him of the need to check title for any easements or restrictions which might interfere with the construction of a pool until the buyer made an inquiry.

The listing agent conducted a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, he knew nothing about any such easement and, importantly, had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a visual inspection.

Reliance on unconditional statements

Since the buyer made an inquiry (boundaries) and announced an intended use of the property (build), the information about the subject matter of the inquiries and the announced use became *material facts*. When a listing agent responds, as he must, to an inquiry by a prospective buyer and gives information

without conditionalizing his statement, **the buyer may rely** on the information and proceed to acquire the property without further confirmation of the accuracy or truthfulness of the information.

Here, due to the inquiry, the listing agent should have included a **contingency provision** in the purchase agreement. Then, the buyer would have been required as a condition of closing to further investigate. Thus, if the results of the due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer, he could have cancelled the transaction.

Without the inquiry from the buyer, the listing agent would not have volunteered his opinion about the location of the boundaries. Thus, without the inquiry he would not have gone beyond his minimum required disclosures about the physical condition of the property. Once he did respond to the request of the buyer, a contingency provision for further approval of the condition included in the purchase agreement would have avoided the dispute (and possibly the sale).

In response to an inquiry

A listing agent owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property. However, when the listing agent responds to an inquiry by the prospective buyer by providing information on the easement, he must state fully and fairly, without deceptive or misleading wording, his knowledge about the easement.

Further, he must **identify the source** of his information if he has not confirmed its accuracy or correctness, or **condition his response** in such a way as to prevent the prospective buyer from justifying any reliance on the information without further investigation.

Consider a prospective buyer who has no experience in real estate matters. The prospective buyer deals directly with the listing agent of a property which seems suitable to the buyer. The prospective buyer observes a 30-foot easement on the subdivision map running the entire width of the frontage to the property. He asks the listing agent what the easement is about. The listing agent responds, explaining it is "for those water lines you find on the curb of the street, it is nothing to worry about."

The prospective buyer decides to buy the property and build a home on it. In escrow, the preliminary title report also reflects the easement. On further inquiry by the buyer, the listing agent again assures the buyer the easement is on the front side of the lot and is not a problem due to the large setbacks.

After close of escrow and commencement of construction of a residence, the local water company digs a ditch 16 feet deep and installs a major waterline. The interference of the easement causes the buyer to relocate his driveway to the side street entrance since placing the driveway over the easement would require the buyer to remove it at his expense should the water company again need to access the easement in the future.

The buyer makes a demand on the listing agent for lost value paid for the property. The buyer had relied on the listing agent's representation that the easement presented no problem to his use of the property, when in fact it did.

Here, the listing agent, having responded to an inquiry from the prospective buyer on the nature of the easement, must be candid in his explanation. The buyer must be informed about the significance of the buyer's limited ability to use the portion of the lot burdened by the encumbrance of the easement. Instead, the listing agent gave evasive answers calculated to stifle and avoid the buyer's further investigation into the true facts about the burden placed on the property by the easement.

Since a material fact is involved, the buyer's inquiry is entitled to a response based on the listing agent's working knowledge of the underlying facts or by identifying the source of the information given. If the listing agent lacks sufficient knowledge to comment, he is duty-bound to say so.

Ads based on seller information

A listing agent may use information obtained from a seller concerning the size of a property in an **advertisement** offering property for sale, such as stating a parcel contains more than one acre or a home contains 5,000 square feet. The listing agent does not need to investigate whether this information is accurate as long as it is not known to the agent to be false. Further, the agent does not need to identify the seller as the source of the data in his advertisement.

As for the advertisement used to locate buyers, the figure given must be consistent with the **observations** made by the listing agent while conducting his visual inspection of the property, e.g., does the property look like it contains more than one acre or look like a 5,000 square foot improvement? However, the listing agent is not required to measure the property or check the public records.

Conversely, in **response to an inquiry** from a prospective buyer expressing an interest or concern about the size of a parcel or improvement, the listing agent must either confirm the accuracy of the area or size, or attribute the information to a source.

For income-producing property, the operating income and expense data received from the seller can be passed on to the buyer or the buyer's selling broker and agent by the listing agent without either confirming its accuracy or disclaiming any responsibility for its correctness.

However, no matter how the data is presented to the prospective buyer, the listing agent is the *conduit for information* received from the seller. The listing agent must first **review it** and, if he has no knowledge the data might be suspect, inaccurate or a misrepresentation, provide it to the prospective buyer and indicate the seller is the source of the data.

By giving the source of the information, the listing agent demonstrates the information does not constitute **the opinion** of the listing agent.

Sufficient notice to alert the buyer

Consider a listing agent of a condominium unit who is aware other units in the project have suffered water intrusion damage. Also, he is aware the homeowners' association (HOA) has filed a lawsuit against the developer to recover the cost of repair for the water intrusion damage in the affected units.

The agent conducts his statutorily mandated visual inspection of the unit, but finds no visible signs of water damage in the unit. The seller claims none exist.

A prospective buyer is located who is not represented by a broker. The seller's Condition of Property (TDS) disclosure on the property's physical condition, which includes the listing agent's observations, is handed to the buyer.

The TDS discloses the seller and the listing agent know of no water intrusion damage in the seller's unit. Further, the listing agent advises the prospective buyer about the existence of HOA litigation over water intrusion damage in other units within the project. The buyer does not further inquire or comment on the HOA litigation or water damages to the project.

The buyer then makes an offer to purchase the property as prepared by the listing agent. The offer contains wording acknowledging the buyer's awareness of the HOA's water intrusion lawsuit and receipt of the TDS, as well as other mandated disclosures.

Later, the listing agent receives newsletters and minutes from the HOA's meetings which further discuss the previously disclosed water intrusion problems. The listing agent also reads the HOA's complaint against the developer. The documents contain no new information and are not brought to the attention of the buyer.

Escrow closes and the buyer moves into the unit. Later, the buyer discovers pre-existing water intrusion damage to the unit.

The buyer claims the listing agent owed him a **general duty** to pass on all documents known to exist concerning the **extent** of the water intrusion damage in the development, such as the newsletters, minutes from the HOA meetings and a copy of the lawsuit filed by the HOA.

Did the seller's listing agent sufficiently inform the buyer about the water intrusion problem to **place the buyer on notice** that a water intrusion problem existed?

Yes! The listing agent disclosed the essential facts necessary to notify the buyer about the water intrusion damage. Once informed of the potential problem within the project, it was the buyer's duty (or the buyer's agent's duty) to exercise reasonable care to protect the buyer.

With notice of the problem, any further details concerning the extent or nature of the water intrusion were **readily ascertainable** by the buyer on request of the listing agent, the HOA or a third-party investigator. It was not the duty of the listing agent to also advise the prospective buyer to investigate the consequences of the facts disclosed before deciding to buy. [**Pagano** v. **Krohn** (1997) 60 CA4th 1]

Also consider a seller who previously received a Solar Shade Control Notice from his neighbor, who subsequently installed a solar energy collector on the neighbor's property.

While the seller is not mandated by law to voluntarily give a copy of the notice to any prospective buyer, the listing agent should have the seller hand the notice to the buyer or the buyer's agent when delivering the TDS. A prudent buyer's agent will likely include a solar shade notice contingency in the purchase agreement. [See **first tuesday** Form 150 §11.12]

Trees or shrubs which shade more than 10% of a solar energy collector can be deemed a nuisance. Having the seller voluntarily give a copy of the notice to the buyer protects the seller and the listing agent from claims of misrepresentation by omission and gives the buyer sufficient notice to alert him to conditions which might affect the buyer's future use of the property. [Calif. Public Resources Code §25982.1]

Editor's note — If the seller sent notices to neighbors prior to installing a solar energy collector, he should voluntarily provide the buyer who purchases the property with a list of everyone he sent the notice to.

Minimum level of disclosure

A listing agent locating a prospective buyer for his client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a reasonably diligent **visual inspection** of the property for defects which adversely affect the value of the listed property. On completing the inspection, the listing agent must note on the (seller's) TDS any defects **observable or known** to the listing agent which are

not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers *as soon as practicable*. [CC §§2079 et seq.]

However, the visual inspection and investigation of one-to-four unit residential property by the listing agent and the disclosure of his knowledge and observations excludes other readily available information, such as:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and
- the inquiry into or review of **public records** or permits concerning title or use of the property. [CC §2079.3]

However, the minimum disclosure rule does not apply to a buyer's broker or his agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigation the buyer should undertake.

Further, the minimum one-to-four unit inspection and reporting requirements imposed on listing agents excludes the **common law duty** still imposed on listing agents of other types of property to further investigate and disclose to buyers or sellers any material facts he discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

Purpose of inspection

The one-to-four unit disclosure limitation on listing agents serves to set a minimum level of information and data to be disclosed to put the buyer and the buyer's agent on **notice of physical defects** in the property which are **observable or known** to the seller or the listing broker and his agents.

For example, an agent lists a residence located on a hillside. The property is subject to natural geological hazards including a high groundwater level, landslides and a fault line.

A prospective buyer for the property is located by the listing agent. The buyer is informed a neighboring owner has had problems with underground water on his property and that he installed a pump to manage the high water level. The listing agent also tells the buyer the neighbor's property previously suffered landslide damages.

The listing agent provides the buyer with a geological report the seller had acquired regarding the property. The report indicates the property lies within a geological hazard area and is susceptible to landslides and groundwater buildup.

The buyer is also informed a back fence was removed since erosion caused it to slide down the hillside. When asked by the buyer, the seller also discloses the pool is located in the front yard since a fault line runs through the backyard.

After a review of the disclosures, the buyer makes an offer to purchase the property.

The listing agent prudently includes a **further-approval contingency provision** in the purchase agreement. The contingency provision calls for the buyer to further investigate the hazards by obtaining his own geological report and approving it as a condition of closing.

Before closing, the buyer obtains a report which states the property shows signs of instability and confirms that a high groundwater level exists. The report also states the house does not show signs of cracking or distress.

During the escrow period, the listing agent attends a meeting between area homeowners and county officials in which the geological hazards of the properties in the area and possible solutions are discussed.

The listing agent does not inform the buyer of the occurrence of the meeting or the topics discussed since no information previously unknown to the agent and undisclosed to the buyer was released.

Later, after escrow closes, the residence slides down the hillside and is condemned by the county as uninhabitable.

On a complaint filed by the buyer, the Department of Real Estate (DRE) attempts to revoke the listing agent's license claiming the subject matter of the meeting held by county officials was itself a fact which should have been disclosed to the buyer by the listing agent since the mere occurrence of the town hall meeting might have affected the buyer's decision to buy.

However, the listing agent was the **exclusive representative of the seller** of one-to-four residential units and only had a general nonfiduciary duty of disclosure to the buyer, which is limited to:

- providing the buyer with all existing geological reports held by the seller or the agent; and
- disclosing groundwater and landslide problems known to the listing agent which occurred on the property or in the neighboring area.

Here, the listing agent properly disclosed the geological hazards of the property by alerting the buyer to the potential problems. The homeowners' meeting was not required to be brought to the buyer's attention since the meeting was a review of the same geological hazards already known to the agent and disclosed to the buyer. Also, the buyer's independent investigation under the further-approval contingencies did not deter the buyer from proceeding with the purchase of the residence.

Thus, the listing agent did not violate the limited general nonfiduciary duty he owed to the nonclient buyer to disclose sufficient information on adverse property conditions to put a prospective buyer on notice so he (or the buyer's agent) could take steps to protect and care for the buyer's best interests. Thus, the DRE cannot revoke the listing agent's license for limiting his disclosures to the initial notice of the defect in the property without further elaboration. [**Vaill** v. **Edmonds** (1991) 4 CA4th 247]

Chapter 10 Opinions with erroneous conclusions

This chapter discusses how an opinion formed by a broker or his agent, given to a prospective buyer to predict a future event or activity regarding the use and operation of a property, might impose liability should the opinion prove to be erroneous.

When an opinion becomes a guarantee

Occasionally, a buyer will ask either a listing agent or his own agent what the agent "believes, contemplates, anticipates or projects" will occur based on the agent's greater knowledge about the condition of a property.

The response of the **buyer's agent** to the buyer's questions about disclosures made by the listing agent will naturally be limited to the agent's knowledge and expertise on the subject. However, the opinion given in response will speculate, based on the observations, knowledge and beliefs of the agent, on the likelihood an event or condition will occur in the future. These statements by the buyer's agent to his buyer are either:

- couched in words of anticipation, estimation, prediction or projection, denoting it is a **mere opinion** about an uncertain future event; or
- worded as an assurance the events and conditions, as presented, will occur, a response reaching the level of a **guarantee**.

The difference between the wording used by an agent to express either an opinion or a guarantee creates the liability the agent is exposed to when:

- the buyer **acts in reliance** on the information by making an offer to buy or eliminating a contingency and acquiring the property; and
- **the event or condition fails to occur**.

An **opinion** is a statement by a broker or his agent, given as his contemplation concerning an event or condition which has not yet occurred. To be classified as an opinion, the statement must be developed by the agent based on **readily available facts** and his **knowledge** and **expertise** on the subject.

It is the nature of an opinion that the event or conditions speculated to come about need not actually occur. The **speculation** is about an uncertain future event or condition.

In an opinion, the event or condition expressed is not a factual representation. The event or condition expressed has not occurred and does not exist at the time the opinion is given. A **fact** is an existing condition, presently known or knowable by the agent due to the ready availability of data or information. Facts are the subject of disclosure rules, not the rules of opinion.

Special circumstances impose liability

A statement made to a buyer by any agent which **predicts** the future occurrence of an event, activity or condition is an *opinion*. The general rule is that the agent and his broker cannot be held responsible when the prediction given in an opinion does not come to fruition.

However, several **special circumstances** may surround an agent's giving of an opinion and raise his statement to the status of a *misrepresentation*.

If special circumstances exist, the broker and his agent are **exposed to liability** for the losses caused by the failure of the predicted event, activity or condition to occur.

Special circumstances which may cause a failed prediction to be an actionable misrepresentation include:

- an opinion which is given by an agent acting as the representative of the person who relies on the opinion, such as occurs between the listing agent and his seller or the buyer's agent and his buyer, called a *fiduciary agency relationship* [**Ford** v. **Cournale** (1973) 36 CA3d 172];
- an opinion which is given to a buyer by a listing agent who holds himself out as **specially qualified** or possessing **expertise** about the subject matter of the transaction [**Pacesetter Homes, Inc.** v. **Brodkin** (1970) 5 CA3d 206];
- an opinion which is given by a listing agent (or his seller) who has **superior knowledge** on the subject matter of the opinion under circumstances implying the agent (or the seller) has **inside information** not available to the buyer which makes the prediction worthy of reliance [**Borba** v. **Thomas** (1977) 70 CA3d 144]; or
- an opinion which is given to a buyer by a listing agent who **could not honestly hold or reasonably believe** the truth of his opinion due to facts known or readily available to him. [**Cooper** v. **Jevne** (1976) 56 CA3d 860]

An opinion based on facts

An **opinion** is an honestly held belief based on a reasonable (although sometimes faulty) analysis of property information known or readily available to the agent giving the opinion. However, the opinion does not by itself create any liability should the event not occur. A special condition needs to envelope the opinion to impose liability.

Consider a prospective buyer who is interested in acquiring a lot within a subdivision track and building a home on it.

The subdivider's listing agent, based on subdivision maps and discussions with the subdivider, advises the buyer all the lots in the entire tract of land are going to be the same size and subject to the same use restrictions requiring all homes built on the lots to be worth at least $400,000.

The buyer purchases the lot and builds his home in accordance with the use restrictions.

Due to an economic downturn at the end of the current business cycle, the subdivider resubdivides the remaining unsold lots and removes the use restrictions. The resubdividing is intended to increase the marketability of the unsold lots in the tract.

The buyer now seeks to rescind the purchase and recover his entire investment claiming the subdivider's agent made false representations about the subdivision which the buyer relied on to purchase the lot.

The subdivider's agent claims he honestly believed in the truth of his representations that the subdivider would not in the future alter the lots remaining to be sold.

Here, the agent's representations about the lot size and the Covenants, Conditions & Restrictions (CC&Rs) the subdivider would require in the future were made truthfully, with no intent to deceive the buyer. Both the agent and the subdivider had a reasonable basis for believing changes would not be necessary at the

time of the purchase. However, a later shift in the economy warranted the changes as necessary to prevent the tract from deteriorating in its marketability.

The listing agent's statements about the future were **honestly entertained**. Thus, his statements qualify as an expression of his opinion.

Further, the buyer **did not reasonably rely** on the listing agent's opinion when he agreed to purchase the property. The buyer did not require the deed from the seller to include a grant of the promised rights that all the lots would be the same size with the same restrictions on minimum value. [**Meehan** v. **Huntington Land & Improvement Co.** (1940) 39 CA2d 349]

Conditional opinions

Special circumstances surrounding the giving of an opinion may create an environment in which the buyer, with good reason, **may rely** on the agent's opinion to make decisions.

Consider a developer of a residential duplex subdivision who provides his listing agent with a schedule of **projected rents**. The agent is instructed to inform prospective buyers these rents are estimates of the amounts obtainable from the duplexes should they buy one.

The developer has not developed properties in the area prior to this project. Also, he has no actual knowledge of the rents a duplex might obtain in the area.

A buyer with minimal investment property experience in the area contacts the agent for information about the duplexes being built.

The buyer is advised by the agent that "if you receive the rents we contemplate, it will be a good investment."

The buyer purchases a duplex, but is unable to locate tenants willing to pay the rental amounts the agent gave in his opinion. Ultimately, the buyer loses the property to foreclosure.

The buyer makes a demand on the agent and the agent's broker for the loss of his invested funds. The buyer claims the agent's statements about the property's future rental income were misrepresentations, which the buyer relied on to purchase the duplex, since the broker, his agent and the developer had **superior knowledge** about rental conditions in the area.

The broker claims the statement his agent made about rental amounts was a mere opinion since it **conditioned success** on collecting these amounts.

Here, the agent's statement was only an estimate or opinion he held about future anticipated rental income for a new development since no operating history existed to draw on when making the projections. Thus, his opinion was based on **all readily available information.**

Also, the buyer's lack of experience as an owner of investment property, the agent's choice of words, i.e., "if" and "contemplate," and the developer's lack of prior rental experience in the area or knowledge of rents actually attainable by the duplexes made the statement an opinion. Thus, the buyer could not rely on the rent projections given by the adversarial listing agent as a fact which could reasonably motivate his decision to buy. [Pacesetter Homes, Inc., *supra*]

Conclusions drawn from opinions

An opinion given by a listing agent predicting the future occurrence of an event or condition concerning the buyer's use or management of a property does not impose liability on the listing agent for erroneous conclusions when the buyer is or has been made **aware of all the relevant facts** on which the agent's opinion is based.

Also, a buyer who has knowledge of and **equal access** to the same information and documents relied on by the listing agent to form his opinion, and has sufficient **time to conduct** his own independent investigation to ascertain the accuracy of the agent's opinion, cannot later claim he acted in reliance on the listing agent's opinion. This is especially true for buyers who possess the expertise needed to analyze the facts and make their own determination about the likelihood the agent's predictions will occur.

Thus, the buyer cannot ignore his own knowledge of the same facts used by the listing agent to develop the agent's opinion and then claim he relied on the listing agent's opinion as an assurance the prediction would occur.

Consider a leasing agent acting on behalf of a prospective tenant in lease negotiations with an experienced commercial landlord who has not retained the services of a real estate agent.

The leasing agent tells the landlord that "in my opinion" the tenant's annual gross sales receipts will be in excess of $5,000,000. After several months of negotiations conducted between the tenant's leasing agent and the seller's attorney, both of whom are very experienced practitioners, a lease agreement is entered into. The lease rent is a base monthly amount plus a percentage of annual gross sales receipts over $5,000,000. The landlord pays the leasing agent's fee.

A dispute erupts between the landlord and the tenant. The landlord now wants to recover the fee he paid the tenant's agent, claiming the agent actually represented the potential gross sales receipts as $7,500,000, an amount much higher than the sales the tenant would ever experience during the leasing period. Thus, the landlord would receive very little if any percentage rent above the fixed minimum rent.

Here, the tenant's agent prefaced his statements with the words "in my opinion." Also, a landlord cannot reasonably rely on or treat the representation of future gross sales as an event which will actually occur.

Thus, the landlord should have known the gross receipts prediction was just an estimate honestly made by the agent who represented the tenant. He could not treat the estimates of the adversarial agent as fact.

Further, the landlord had ample time and the means to make his own inquiries and analyze his findings. Since the landlord was not represented by a real estate agent, he should have conducted his own due diligence investigation if he intended to eliminate the uncertainties of estimates made on behalf of the tenant by the tenant's agent. [**Foreman & Clark Corporation** v. **Fallon** (1971) 3 C3d 875]

Opinions of the buyer's broker

A **seller's broker** and listing agent, acting exclusively on behalf of a seller, have only a *general non-agency duty* to deal honestly and in good faith with a prospective buyer. As for a buyer, the listing agent's opinions are those of an adversary.

Thus, a listing agent's opinion cannot be reasonably relied upon by a prospective buyer as having a high probability of occurring, unless **special circumstances** surround the agent's act of giving an opinion.

In contrast, a **buyer's broker** and his agent have a *special fiduciary (agency) duty* to handle a buyer with the same level of care and protection a trustee would exercise on behalf of his beneficiary.

This **special agency duty** owed to a buyer raises an opinion given to a buyer by the buyer's broker or his agent to a higher level of reliability than had the same opinion been expressed by a listing agent acting solely on behalf of a seller. Thus, as a fiduciary, the opinion of the buyer's agent becomes an **assurance** that the condition or event which was the subject of the opinion will occur, unless the buyer's agent *conditionalizes* his opinion.

For the buyer's agent to give his opinion to his buyer and keep it from rising to an actionable assurance, the advice given with the opinion must include a **recommendation** to investigate and expertly analyze relevant information in order to confirm the agent's opinion. Further, a **contingency provision** covering the condition or event that is the subject of the opinion needs to be included in any offer the buyer makes and the contingency must be eliminated before closing. [Borba, *supra*]

Assurance of suitability without a contingency

Consider a buyer's agent who represents a prospective buyer looking for rental income property.

The buyer's agent is aware that the buyer's primary purpose for acquiring property is to receive a minimum amount of spendable income from the investment.

The agent locates a multi-unit apartment complex. The agent assures his buyer that:

- monthly vacancies will only be three or four units since the apartment complex is the only complex in the area which allows children and pets;
- the complex will require very little expense to maintain; and
- the buyer will receive the amount of spendable income sought from the investment.

Even though the seller's books and records are **readily available** for inspection, the buyer's agent does not verify the accuracy of the seller's income and expense statements, or confirm the maintenance costs. Without doing so, the agent fills out and hands his buyer an Annual Property Operating Data (APOD) sheet restating the representations already made to the buyer about the agent's projections of future income. [See Form 352 accompanying Chapter 22]

The buyer, in reliance on his agent's predictions about the property's future operations, enters into a purchase agreement with the seller as prepared by his agent. No **contingency provisions** are included to confirm the integrity of the improvements or to investigate the income and expenses experienced by the seller.

After the buyer acquires the property, the buyer encounters higher maintenance costs and significantly lower rental income than represented by his agent. Also, the property has a high turnover rate and a large number of tenants are constantly delinquent in the payment of rent.

The buyer does not receive the sought-after minimum spendable income projected by his agent. Soon, due to persistent negative cash flow, the property is lost to foreclosure.

The buyer makes a demand on his agent for his lost investment, claiming the agent misrepresented the operations of the property. The buyer's agent rejects the demand, claiming his comments on the property's performance were opinions, not guarantees.

Here, the buyer had the **right to rely** on his agent's unconditional statements of facts about the property and treat them as true without concern for their verification since a fiduciary relationship existed between the buyer and his agent.

Thus, the buyer's agent's **predictions were misrepresentations**, the basis for the buyer's recovery of the value of the lost investment. The unfounded and careless predictions of the buyer's agent, given in an opinion as fact, constituted *deceit*, a form of misrepresentation. [Ford, *supra*]

Expertise of the broker or agent

Agents are known to be specialists and often properly hold themselves out as experts with **superior knowledge** about a particular type of transaction, such as high-end residential properties, apartment projects, industrial buildings or land. Prospective buyers, aware of a listing agent's specialty, often ask the agent for his opinion about some anticipated future use or operation of the property.

Due to an agent's experience, special training and education in a particular aspect of a property or type of transaction, agents may find their opinion is given extra weight by a buyer. An agent's **special qualifications** suddenly become *reasonable justification* for the buyer to rely on their opinion as an **assurance** that the predicted event, activity or condition will actually be experienced as stated.

Thus, an agent's wording of his opinion needs to express that the opinion is **only his belief** or his thought on the matter. Having expressed an opinion, the agent then needs to include a further-approval contingency calling for the buyer to confirm information given in the opinion.

Consider a developer who controls a homeowners' association (HOA) which governs a subdivision of homes he is marketing to prospective buyers as having a panoramic view of the countryside.

The developer and his listing agent hold themselves out **as experts** in the establishment and administration of HOAs when questions about HOA operations and the Covenants, Conditions and Restrictions (CC&Rs) are received from prospective buyers.

The listing agent assures prospective buyers that the subdivision's CC&Rs protect the view from each lot, that any future landscaping or fencing requires approval from a special architectural committee, and that the committee will not approve fences or landscaping which interfere with the view. The recorded CC&Rs contain provisions for the committee and view protection which confirm the agent's statements.

However, an architectural committee is never setup. Further, all proposals for fences are reviewed and approved by the developer himself, a fact known to his agent, but not to prospective buyers. A prospective buyer pays a premium for a view lot improved with a home which has a panoramic view.

After acquiring the property, a neighbor erects a fence as approved by the developer. The fence blocks the buyer's view. The buyer makes a demand on the agent for his money losses brought about by a loss in value suffered by his property since the agent's statement on view rights failed to come true.

The listing agent claims his statement about the view rights was his opinion, given as a representative of the seller, a statement which could not be reasonably relied on by the buyer when making a decision to purchase the property.

Here, the agent held himself out as **an expert** on association management and CC&Rs enforcement. The agent then stated the CC&Rs and architectural committee would maintain the view provided by the development.

However, the listing agent knew the committee required to make such decisions had not been created and that the developer himself had full control. Thus, the buyer could pursue the agent to recover his lost value, i.e., the view, due to his false opinion about the HOA's ability to protect the buyer's view rights in the future.

When an agent holds himself out to be *specially qualified* and informed in the subject matter expressed in his opinion regarding future expectations, his opinion becomes a **positive statement of truth** on which a buyer or seller of lesser knowledge can rely. [**Cohen** v. **S & S Construction Co.** (1983) 151 CA3d 941]

Inducing reliance by assurances

All agents give opinions to buyers predicting all sorts of events or conditions the buyer will experience after acquiring a property. However, when the opinion is **coupled with advice** expressing no further need for the buyer, or others on behalf of the buyer, to investigate and confirm the prediction, the opinion is elevated to the level of a *guarantee*.

The level of assurance equivalent to a **guarantee** also arises out of a buyer's indication to an agent that the buyer is relying on the agent:

- to analyze a qualifying property to determine the property's ability to be used or operated as the buyer has indicated; and
- to advise on whether the property is suitable and will meet the buyer's expectations.

Also, any affirmative activities or statements of any agent designed to **suppress the buyer's inspection** of the property, his inquiries of the owner or the owner's manager or agents, or the employment of other experts when the agent knows the buyer will rely on the agent's representations, are considered assurances which make the conclusion drawn in the opinion the equivalent of a fact.

If the predicted event or condition does not come to pass and it was the **buyer's agent** who suppressed the buyer's due diligence activities, the buyer's agent is liable for the lost *benefit of the bargain* he predicted would occur. Recovery includes projected net spendable income, not just the loss of the price paid.

As for the **listing agent's liability** to the buyer under the same circumstances, liability is limited to the loss of the price paid and no future losses such as a profit or other return on the investment are collectable.

Facts not supporting the conclusion

An agent's opinion must be a belief honestly held by the agent if the agent is to avoid liability when the predicted event or condition does not occur. For an agent to hold an **honest belief**, the opinion must be formed based on a due diligence investigation and knowledge of all readily available facts which have a bearing on the probability of the event or condition occurring.

When facts affecting the conclusion drawn by the agent in his opinion are known or readily available to the agent, the test of an *honestly held opinion* is whether the agent giving the opinion **should have known better** than to give such an opinion.

Thus, an agent who fails to conduct a due diligence investigation to determine the facts before expressing an opinion which the investigation would have influenced will be liable for his opinion as a misrepresentation should the event or condition fail to occur, no matter his wording to limit the prediction to a mere speculative opinion.

Without first having the facts on which to base an opinion, the agent's opinion is either an *unfounded guess* or an *unreasonable assumption* about events and conditions he predicts will occur in the future.

Consider a listing agent for a condominium project who advertises "luxury" condos for sale. The agent knows the condos are poorly constructed and that the defects are unobservable to someone not knowledgeable in the field of construction.

A buyer contacts the agent for more information.

The agent tells the buyer that the condos are an "outstanding" investment opportunity. Unaware of the defects, the buyer purchases a condo.

The buyer soon discovers that the building housing the condos is in danger of falling down.

Here, the listing agent (and his broker) are guilty of both *affirmative* and *negative fraud*.

By telling the buyer that the condos were an outstanding investment opportunity, an opinion the agent could not have **honestly held** in light of his knowledge of the construction defects, the agent's representation is an **affirmative fraud**, also called an *intentional misrepresentation*. The agent should have known better than to give such an opinion.

Also, the significant defects in the "luxury" project were **material facts** since they adversely affected the present value and desirability of the condos. Accordingly, the agent is liable for damages caused by his nondisclosure (omission) of the defects which were known to him, but unknown and unobservable by the buyer, an example of a representation which is a **negative fraud**, also called *deceit*. [Cooper, *supra*]

Predicting the conduct of others

The transfer of real estate to a buyer typically involves **third parties** who are not principals or agents in the transaction. Approval, consent, administrative review and other like-type **conduct by others** regarding some event or condition which is to occur before or after closing, cause buyers to be concerned about whether the third party will respond favorably to the proposed transaction. As a result, buyers ask agents what they believe might be the **reaction of others**, such as a HOA, water authority, landlord, contractor, lender, attorney, accountant, planning agency or redevelopment agency.

Consider agricultural land listed for sale. For a buyer to receive water from the Bureau of Reclamation, the buyer must obtain approval of the purchase price from the Bureau, a third party.

The listing agent locates a buyer.

A purchase agreement is drawn up contingent on the Bureau's approval of the purchase price. The agent estimates the approval process will take 30 to 60 days.

The buyer, concerned with meeting the planting deadline for this season, asks the agent about the probability of the Bureau's approval.

The lisgint agent consults with the seller as to whether the transaction would be approved by the Bureau since the seller has dealt with the Bureau over water issues before.

The seller says "he believes" it would.

The agent tells the buyer of the seller's opinion on Bureau approval. The buyer waives the Bureau-approval contingency, stating he will get the approval later. Escrow is closed.

The buyer files for Bureau approval of the sale when the property's natural well caves in.

The Bureau refuses to approve the transaction. Thus, the Bureau will not provide water.

The buyer seeks to recover his losses from the seller, claiming the seller's prediction of a future event (approval by the Bureau) was a fact on which he could rely in his purchase of the property.

However, nothing suggests the seller or his agent held themselves out to be **specially qualified** on the subject of Bureau approval. Thus, the seller's erroneous prediction about the approval was not a misrepresentation of fact, but a mere expression of his opinion.

The seller's access to and awareness of facts concerning the Bureau's approval process or likelihood of approval were either **known or equally available** to the buyer. If the buyer is curious about the details and paperwork needed for the approval, the buyer (or his agent) is duty bound to contact the Bureau himself.

Furthermore, unless a **special relationship** exists between the seller and buyer, the buyer is not entitled to rely on the opinion of the seller (or the listing agent) concerning the future decisions of a public body, in this case, the Bureau of Reclamation. [Borba, *supra*]

When the buyer has ready access to the third party, the **buyer's reliance** on the opinion of the seller's listing agent is *unjustified*. All the buyer need do to answer his own inquiry is contact the person involved and inquire himself.

As for a buyer's agent, his response to his buyer's inquiry may be an opinion on the probability of a positive or negative reaction by the third party, but must be accompanied with the advice to make the offer to purchase conditioned on getting the approval. If the contingency already exists, then get the approval to satisfy the contingency or be disapproved and cancel.

Estimates as projections or forecasts

Estimates presented to prospective buyers by agents are labelled with many titles and arise in a variety of real estate transactions. Every transaction offers agents the opportunity to provide estimates for their clients or the other principals involved. Estimates include approximations, predictions, pro-forma statements, anticipated expenditures and contemplated charges.

Estimates relate to income and/or expenditures, such as exist in:

- seller's net sheets;
- buyer's cost sheets;
- operating cost sheets for owner-occupied properties;
- APODs on income properties;
- loan origination or assumption charges;
- lender impounds;
- rent schedules (rolls);
- repair costs for clearances; and
- any other like-type predictions of costs or charges.

Estimates by their nature are not facts. The amounts estimated have not yet actually occurred. The amount estimated will become certain only by its *occurrence in the future*. The amount actually experienced may or may not equal the amount estimated.

A document entitled an “estimate” is typically based on the actual amount which would currently be experienced. Thus, estimates are expected to be quite **accurate in amount**, not just a guess. Words used in titles such as “contemplated,” “pro-forma,” “anticipated” or “predicted” indicate something less than an accurate estimate and provide less basis for a client to rely on them as an assurance they will occur.

Distinguish projection from forecasts

Opinions voiced by agents about an income property’s future performance fall into one of three general categories:

- *projections*;
- *forecasts*; or
- *unfounded opinions*.

A **projection** is prepared by a listing agent on a property’s annual operations using an APOD sheet which will be handed to prospective buyers to induce them to purchase the property. The data entered on the APOD by the agent is a projection based exclusively on the income and expenses **actually incurred** by the owner/seller of the property during the preceding 12-month period.

The amounts experienced by the owner/seller during the past year are **projected to occur** (again) over the next year, *adjusted* by the agent for any trends in income and expenses reflected by information currently available or presently known to the owner or the agent.

Trend information is used in a projection to make mathematical adjustments to income and expenses based on market conditions or implementable rent control increases, and to operating costs known to be increasing (or decreasing) by prior announcements of the providers.

Thus, the past year’s operations experienced by the property are anticipated to be repeated, as adjusted, and occur again during the first 12 months of operation by a new owner. No estimations, contemplations or use of figures other than those experienced by the owner are used to prepare a projection, except for adjustments to reflect changed conditions known (or should be known due to readily available facts). If these adjustments are not included in the projection, the opinion is not honestly held since it would be an opinion not actually held or not reasonably held by the agent or seller preparing the projection.

A **forecast** is an entirely different opinion from a projection, although both are based on beliefs about events and conditions which are honestly believed will likely occur in the future.

A forecast requires the knowledge and analysis of an anticipated change in circumstances (other than trend factors used for projections) which will influence the future income, expenses and operations (use) of a property. Forecasts anticipate **forward changes** in income and expense the preparer of the forecast believes will probably occur under new or developing circumstances.

Changes in circumstances which might affect the income, expenses and debt servicing the buyer **should experience** during the 12-month period following the close of escrow and would be considered in a forecast include:

- new management;
- rent increases up to current market rates;
- elimination of deferred maintenance and replacement of obsolete fixtures/appliances (renovation);
- changes in rent control ordinances;
- new construction adding to the supply of competing income properties;

- foreclosures adding less expensive properties to the market;
- commodity market prices (natural gas, water, fuel oil, electricity, etc.);
- local and state government fiscal demands for revenue and services (taxes);
- federal monetary policy effects on short-term and long-term rates (controlling any ARM loans encumbering the property or refinancing);
- demographics of increasing/decreasing population density in the area immediately surrounding the property (age and appreciation for the location);
- traffic count changes anticipated (due to traffic buildup or diversions);
- zoning changes reducing, altering or increasing the availability of comparable competitive properties;
- government condemnation, relocation or redevelopment actions;
- changes in the local employment base of employed individuals;
- on-site security measures for the prevention of crime;
- the age and condition of the major components of the structure;
- local socio-economic trends; and
- municipal improvement programs affecting the location of the property.

Chapter 11 Safety standards for improvements

This chapter establishes the need for the seller and listing agent to make disclosures about the property's noncompliance with current safety standards before acceptance of a buyer's offer.

Disclosing noncompliant improvements

A seller of a one-to-four unit residential property, who is solicited by a listing agent, enters into a listing agreement employing the agent's broker to locate buyers and sell the property.

The seller is asked to fill out a Transfer Disclosure Statement (TDS) and return it to the listing agent. When the TDS is filled out by the seller and picked up by the listing agent, the agent will conduct his own **visual inspection** of the property as mandated. On completion of the inspection, the agent will note any defects he observed on the TDS and sign it. [Calif. Civil Code §2079; see **first tuesday** Form 304]

The seller fills out and signs the TDS and returns it to the listing agent.

The listing agent then conducts his visual inspection of the property to identify components and defects not disclosed by the seller on the TDS. He **observes several safety conditions** which he knows do not meet current building codes. These observations are noted on the seller's TDS in the space provided above the location for the listing agent's signature.

The disclosure statement signed by the seller and listing agent now reveals that the garage door closing mechanism is not equipped with an automatic reversing device, the spa does not have a locking safety cover, the pool does not have barriers restricting access, the water heater is not anchored or braced, and the security bars on the windows in one of the bedrooms do not have a release mechanism — all in violation of current safety standards.

The TDS and all other seller disclosures and property reports are included as part of a listing package the listing agent will hand to prospective buyers and buyer's agents.

At an open house held on the property by the listing agent, a visitor indicates he is interested in possibly buying the property and asks for more information about the property.

By the visitor's request for additional property information, the visitor has begun **negotiations**. Thus, he has become a *prospective buyer*, entitled to a complete set of disclosures from the seller or the seller's agent before any offer is made.

The listing agent responds to the request by handing the prospective buyer the **listing package** which includes a copy of the TDS for the buyer's review.

A purchase agreement offer is then prepared and eventually signed by the prospective buyer, acknowledging receipt of the TDS and all other disclosures mandated for the transaction. The purchase agreement offer does not contain a provision calling for the seller to correct any of the previously disclosed safety defects or to bring the property up to current building standards.

However, prior to closing, the buyer becomes concerned about the existing safety defects. Also, local ordinances may require the safety defects to be eliminated before issuing the buyer a certificate of occupancy.

The buyer makes a demand on the seller to repair, replace or install an automatic reversing device for the garage door, a locking cover for the spa, barriers to restrict access to the pool, a brace or anchor on the water heater and security bar release mechanisms as necessary to meet current safety standards. The buyer claims the seller must cure the safety defects by meeting current construction standards before the seller can require the buyer to close escrow on the sale.

The seller refuses to cure any of the defects, claiming the buyer must close escrow since the **buyer knew** the defects existed before entering into the purchase agreement and the seller never agreed to correct the defects and bring the property up to current building codes.

Can the seller cancel or enforce the purchase agreement when the buyer refuses to close escrow due to the existence of physical defects in the property known to the buyer before the buyer agreed to purchase the property, which the seller has not agreed to cure?

Yes! The buyer knew the precise condition of the property when he agreed to the price he would pay to purchase the property.

Thus, the buyer agreed to acquire the property "as disclosed" in the seller's TDS. The buyer was **on notice** of the defects prior to his agreement to buy the property and did not bargain for the seller to cure the defects as a condition for paying the agreed price.

Automatic garage doors

All automatic garage doors installed after January 1, 1991 are required to have an automatic reverse safety device which meets code. [Calif. Health and Safety Code §19890(a)]

In addition, garage door openers installed after January 1, 1993 are required to have a sensor which, when garage door movement is interrupted or misaligned, causes a closing door to open and prevents an open door from closing. [Health & S C §19890(b)]

The safety standards for garage doors are designed to prevent children from becoming trapped under closing doors. Property constructed before 1993 probably do not meet current safety standards.

Further, when any residential garage door is serviced, the person servicing the garage door must test whether the door reverses on contact with a two-inch high obstacle placed beneath the door.

If the door does not reverse, the repairman must place a warning sticker on the garage door stating the door does not reverse and is not in compliance with current safety standards. [Health & S C §19890(e)]

Child resistant pool barriers

A construction permit issued after 1997 for a pool at a single-family residence requires the completed pool to comply with **at least one** of the following safety requirements, i.e.,:

- the pool is isolated from access to the house by a surrounding fence or barrier at least 60 inches in height;
- the pool incorporates up-to-code removable mesh pool fencing with a self-closing and self-latching gate that is key lockable;

- an approved safety cover is installed for the pool;
- an up-to-code surface motion, pressure, sonar, laser, or infrared swimming pool alarm is installed in the pool that will sound when it detects accidental or unauthorized entrances into the water;
- all the doors of the residence providing access to the pool are equipped with a self-closing, self-latching device with a release mechanism placed no lower than 54 inches above the floor; or
- some other means of protection as determined to be adequate by an approved testing labratory as meeting certain standards. [Health & S C §115922]

These safety requirements do not apply to hot tubs or spas with locking safety covers.

Condominium and apartment projects are not required to maintain safety barriers for pools and spas as their projects are not classified as single-family residences. Also, pools in condos and apartments are considered public facilities.

However, condo projects and apartment buildings must post signs indicating whether or not lifeguard services are available. Lifeguard services are not required, and if not provided, a sign saying so must be posted. [Health & S C §116045]

Public pools and spas are considered environmental hazards to a user's health if the managers do not operate and maintain them in a sanitary, healthful and safe manner. [Health & S C §116040]

If pools and spas in multiple-housing projects are not operated or maintained in a sanitary, healthful and safe condition, the pools and spas are considered a public nuisance and can be shut down by local health inspectors. [Health & S C §116060]

Water heaters

All existing residential water heaters are to be anchored, braced *or* strapped to prevent displacement due to an earthquake. [Health & S C §19211(a)]

A residential seller must state whether the water heater is anchored, braced *or* strapped. [Health & S C §19211(b)]

If the water heater meets safety requirements, the seller notes the compliance by marking the box on the TDS next to "anchored, braced or strapped." No further notice is necessary as it would be redundant and is not required.

If the seller's water heater does not comply, the seller should include a written statement on the TDS disclosing that fact.

When a prospective buyer receives the TDS before entering into a binding purchase agreement, and the TDS notes the water heater is not in compliance with safety standards, the prospective buyer has agreed to accept the property with the defect, unless a provision to the contrary is included in the purchase agreement.

Residential security bars

Security bars on residential property must have release mechanisms for fire safety reasons.

However, the release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes. [Health & S C §13113.9]

Chapter 12 — The home inspection report

This chapter introduces the seller's and listing agent's use of a home inspection report to document the present physical condition of the listed property for prospective buyers.

Transparency by design

A seller of a one-to-four unit residential property, on entering into a listing to sell the property, is asked to give the listing agent authority to order out a **home inspection report** (HIR) from a local home inspection company as part of the seller's cost to market the property for sale.

The listing agent explains the HIR will be used to complete the seller's Condition of Property (Transfer) Disclosure Statement (TDS). The report will then be attached to the seller's TDS.

On receipt of the report, the seller could act to eliminate some or all of the deficiencies noted in the home inspection report. On the elimination of any defects, an updated report would be ordered out for use with the TDS.

The seller's TDS, as reviewed by the listing agent and supplemented with the HIR, will be used to inform prospective buyers about the **precise condition** of the property before they make an offer to purchase. Thus, the seller will not be confronted later with demands to correct defects or to adjust the sales price in order to close escrow. The property will have been purchased by the buyer "as disclosed."

The listing agent's marketing role

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies primarily with the listing agent. [Calif. Civil Code §2079]

Further, to retain control throughout the process of marketing, selling and transferring ownership, the listing agent should be the one who requests the HIR (on behalf of the seller). The agent will lose control over the marketing and closing process, and expose himself to claims of misrepresentation, when the buyer or the buyer's agent is the one who first orders the HIR.

As part of the listing agent's management of the home inspection activity, the agent should be present while the home inspector carries out his investigation of the property. The agent can discuss the home inspector's observations and whether his findings are **material** in that they affect the desirability, value, habitability or safety of the property, and thus its value to prospective buyers.

If the listing agent cannot be present, then he should request that the home inspector call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations he may have for further investigation. On receipt and review of the report by the seller and listing agent, any questions or clarifications they may have on its content is followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

Home inspector's qualifications

Any individual who holds himself out as being in the business of conducting a home inspection and preparing a home inspection report on his findings during the inspection of a one-to-four unit residential

property is a **home inspector**. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession. [Calif. Business and Professions Code §7195(d)]

However, general contractors, structural pest control operators, architects and registered engineers typically conduct home inspections and prepare reports as requested by sellers, buyers and their agents. The **duty of care** expected of licensed members of these professions by prospective buyers who receive and rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their profession. These licensees are *experts* with a high level of duty owed to those who receive their reports. [Bus & P C §7068]

Home inspectors occaisonally **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their **physical examination** of the property and report their findings. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts. [Bus & P C §7196]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which would constitute the practice of a civil, electrical or mechanical engineer. [Bus & P C §7196.1]

Hiring a home inspector

A seller's broker and listing agent can rely on **specific items** in a home inspection report (HIR) to prepare their final TDS. Their reliance on an HIR prepared by an inspector relieves the seller and the listing broker from liability for errors which are unknown to them to exist. However, to rely on the HIR, they must be free of simple negligence in the selection of the home inspector who inspects and prepares the HIR. Thus, the broker must exercise *ordinary care* when selecting the home inspector.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and listing agent preparing the TDS will not relieve the broker or the listing agent of liability.

However, use of an HIR by the listing agent does not relieve the agent (or his broker) from conducting their mandatory visual inspection. [CC §1102.4(a)]

Thus, the broker and listing agent must look into or be aware of whether the home inspector who prepares the report is qualified. The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

When hiring a home inspector, the *qualifications* to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and

- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and his listing agent to better represent the condition of the property to prospective buyers, and hopefully reduce the risk of errors.

Reliance by buyers on the report

A listing agent requesting a home inspection report should advise the home inspector that the seller, broker and all prospective buyers of the property will be relying on the report. This disclosure will avoid later (unenforceable) claims by the home inspector that the report was intended for the sole use of the seller, broker or buyer who signed the home inspector's contract. [CC §1102.4(c)]

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt of the report, the buyer cancels the purchase agreement. Another prospective buyer interested in the property receives the same home inspection report from the listing agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer can now rely on it, as stated in the home inspection contract under which the report was prepared.

Here, the home inspector knew the listing agent also received the report and should have known that the agent would properly provide it to other prospective buyers if the buyer who ordered the report did not complete the purchase. A home inspection report, like an appraisal-of-value report or a structural pest control report, is not a **confidential document**. Thus, all prospective buyers of the property are **entitled to rely** on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for his failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed regardless of the fact that the home inspection contract and report contained a provision restricting its use solely to the person who originally requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

The home inspection contract

Provisions in a contract with a home inspector and his home inspection company which purport to limit the dollar amount of their **liability for errors**, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report are *unenforceable*.

Further, any provision in the home inspection contract or condition in the home inspection report which purports to waive or limit the home inspector's liability for the **negligent investigation** or preparation of the HIR is *unenforceable*. [Bus & P C §7198]

Should the buyer discover an error in the HIR regarding the existence or nonexistence of a defect affecting the value or desirability of the property, the buyer has no more than four years after the **date of the inspection** to file a legal action to recover any money losses. [Bus & P C §7199]

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will attempt to limit the buyer's period for recovery to one year after the inspection occurred. However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

The home inspector's malpractice insurance

An agent ordering a home inspection report needs to verify the home inspection company has **professional liability insurance coverage** before allowing the company to conduct an investigation and prepare a report.

Home inspectors who fail to detect and report a material defect or the extent of the defect may cause the buyer to incur costs to correct the significant defects. The buyer will be seriously disadvantaged in any recovery effort against the home inspector and the home inspection company unless insurance is available to pay amounts due the buyer.

Likewise, if the same defect was also missed by the listing agent due to the agent's failure to observe the defect during the agent's mandatory visual inspection, the broker and the listing agent are also liable to the buyer for the costs of curing the defect — separate from the home inspector's liability.

Here, the broker and listing agent will be able to force the home inspector to contribute to the recovery by an *indemnification claim* made by the broker against the home inspector for payment of all or a portion of the buyer's loss. Unless the home inspector has insurance coverage, the ability of the seller's broker to force the home inspection company to pay the home inspector's share of the responsibility for having failed to observe the same defect the listing agent missed will be limited to the home inspector's personal assets. [Leko, *supra*]

The inspection and report

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a *noncontingent fee*.

The purpose of the physical examination of the premises is to identify *material defects* in the condition of the structure and its systems and components. **Material defects** are conditions which affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

Defects are material if they adversely affect the **price** a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer must precede a prospective buyer's offer to purchase to be meaningful. [Bus & P C §7195(b)]

AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT

(Business and Professions Code §7195)

DATE: _____________, 20______, at ____, California.

Home Inspector	Agent
Home Inspector/Rep. ____________________________	Agent's Name ______________________________
Home Inspection Company ______________________	Broker's Name _____________________________
Address ________________________________	Address _______________________________
Phone _________________________________	Phone _________________________________
Fax __________________________________	Fax __________________________________
Email _________________________________	Email _________________________________

FACTS:

1. Property address ____
____
1.1 Type of property ____
____

2. Owner's name ____
Phone ____

3. The home inspection report is for use in the agent's preparation of a transfer disclosure statement and reporting of the property conditions to prospective buyers.

4. Your contract for inspection and report will be entered into by ☐ the Owner, ☐ the Buyer, or ☐ the Agent.

4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.

5. Call ☐ the Agent, or ☐ the Seller, to set up the day and time for your inspection.

5.1 ☐ The Agent will be present during the inspection.

5.2 If the Agent is not present, call the Agent to discuss your findings before preparing the report.

6. Your inspection and report to include the following items:

6.1 An energy efficiency inspection.

6.2 Any improvements that are not in compliance with building permits or codes and any improvements for which no permit exists.

6.3 The property's compliance with safety codes for child resistant pool barriers, hot tub covers, automatic garage doors, door locks/latches, gas valves, residential security bars and water heaters.

7. Your fee for this service will be paid in full on your delivery of your report to the Agent.

7.1 It is anticipated the amount of your fee will be $_______________.

8. You are authorized to open an order and process this inspection.

Submitting Agent's Signature: ____

FORM 130 02-08

The **home inspection** is to be a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations. **Non-invasive** indicates there will not be an intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion. [Bus & P C §7195(a)(1); see Form 130 accompanying this chapter]

The **home inspection report** is the written report prepared by the home inspector which sets forth his findings while conducting his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector found or suspects, makes recommendations about the conditions observed and suggests any further evaluation needed to be undertaken by other experts. [Bus & P C §7195(c)]

The listing agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report should also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

The home inspector's conflicts of interest

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company may not:

- **pay a referral fee** or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;
- agree to accept a **contingency fee** arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;
- perform or offer to **perform any repairs** on a property which was the subject of a HIR prepared by them within the past 12 months; or
- inspect any property in which they have a **financial interest** in its sale. [Bus & P C §7197]

Chapter 13 Verify property disclosures: retain a home inspector

This chapter examines the buyer's use of a home inspector to confirm the physical condition of the property, as represented by the seller and listing agent, prior to entering into a purchase agreement.

Protecting the prospective buyer

A buyer, with the assistance of his agent, locates a one-to-four unit residential property suitable for the buyer to purchase. Both the the buyer and his agent walk through the property and confirm the property fits the buyer's needs.

The buyer's agent contacts the listing agent and informs him he has a prospective buyer who is interested in the property. The buyer's agent requests information on the property, including a title profile, a Transfer Disclosure Statement (TDS) and a home inspection report (HIR). The listing agent responds by suggesting the buyer's agent go ahead and submit a purchase agreement offer and that the "necessary disclosures for closing" will be delivered after an offer is accepted by the seller.

The indication the buyer's agent gets is that the listing agent has not prepared a listing package and no information on the property will be made available to prospective buyers until it is time to close escrow.

The buyer agrees with his agent to proceed with an offer at a price and on terms which the agent believes are justified. The agent has checked out comparable sales information provided by the title company, plus he has a working knowledge of properties in the immediate area. They know of no problems presented by the physical condition of the property.

An offer is prepared with contingency provisions regarding the condition of the property. The buyer has no information on the condition of the property except for his walk-through with his agent to determine whether the arrangement of the space within the structure was suitable.

Condition of property contingencies

Contingency provisions included in the purchase agreement, among others, call for:

- the seller to furnish a **HIR** prepared by an insured home inspector showing the land and improvements to be free of material defects [See **first tuesday** Form 150 §11.1(b)];
- the seller and the listing agent to prepare, sign and deliver a **condition of property disclosure** (TDS) [See Form 150 §11.2]; and
- the **buyer to inspect** the property twice — once to initially confirm the condition of the property and once again before closing escrow to confirm maintenance has not been deferred and *material defects* discovered after entering into the purchase agreement have been corrected or eliminated. [See 150 §11.4]

The offer is submitted and promptly rejected by the seller. Eventually, a purchase agreement is entered into which eliminates the provision calling for the seller to furnish a HIR. No previous offer has been submitted to the seller by other prospective buyers who obtained an HIR on the property.

The buyer authorizes his agent to immediately obtain a HIR, which the buyer's agent orders. The inspection takes place and the HIR is received by the buyer's agent and reviewed with the buyer. The seller and the listing agent have not delivered a TDS or any of the other seller disclosures or inspection reports which both the seller and the listing agent are duty bound to deliver to a prospective buyer. [Calif. Civil Code §§1102, 2079]

The home inspector's written report lists numerous significant defects he has observed during his physical inspection of the property's condition. Repair/replacement costs are estimated at $2,500 to eliminate the defects not disclosed by the seller or observed by the buyer or the buyer's agent on their cursory review of the space within the structure.

Demands follow discovery

The buyer makes a written demand on the seller to cure (repair) the defects discovered by the home inspector based on the terms agreed to in the purchase agreement. [See Form 150 §11.4; see Form 269 accompanying this chapter]

A copy of the HIR and a contractor's estimate of the cost to cure the defects are attached to the buyer's request for repairs. Thus, the buyer substantiates his demand on the seller to cover previously undisclosed defects.

The seller and his agent prepare a TDS and note all the defects listed in the HIR and on the buyer's notice demanding repairs. The seller then refuses to make any of the corrections, claiming he has disclosed the defects in the TDS as agreed in the purchase agreement. Eventually, the buyer is told to either close escrow or cancel.

Can the buyer require the seller to cure the *material defects* found by the home inspector and close escrow?

Yes! The seller must deliver the property to the buyer as disclosed by the seller and the seller's broker and observed by the buyer at the time the buyer's purchase agreement offer was accepted, not in the condition stated in an untimely disclosure made in the seller's TDS during escrow.

The seller's and listing agent's failure to disclose prior to acceptance is an omission of facts, called *negative fraud, deceit* or *misrepresentation by omission*.

The most significant issue arising out of these discoveries concerns the price the buyer agreed to pay in the purchase agreement. The seller and buyer agreed on a price for the property based on the conditions **disclosed and known** to the buyer at the time the offer was accepted.

Thus, the price represents the agreed value of a used, but defect-free property, except for any defects observed by the buyer or disclosed to the buyer prior to entering into the purchase agreement. The price, as it turns out, exceeded the property's fair market value by the amount of the costs which will be incurred to cure the defects and deliver the property "as disclosed" prior to acceptance.

Confirm the seller's disclosures

A seller and his listing broker must disclose to a prospective buyer all known and observable property conditions which adversely affect the value of the property.

PROPERTY INSPECTION

Request for Repairs

DATE:_____________, 20______, at____, California.

TO SELLER: ____

FACTS:

1. Buyer entered into a purchase agreement with you dated _____________, 20______ agreeing to buy real estate referred to as ____
____.

2. The purchase agreement calls for an **initial inspection** of the real estate by Buyer, or a representative of Buyer.

2.1 The inspection is to confirm that the condition of the real estate is substantially the condition reasonably expected by Buyer based on observations by Buyer and representations made by Seller or Seller's Agent to Buyer or Buyer's Agent prior to acceptance of the purchase agreement.

3. The purchase agreement calls for Buyer to notify Seller, on completion of Buyer's initial inspection, of any material defects discovered by Buyer which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement.

4. The purchase agreement further calls for Seller to repair, replace or correct the noticed defects prior to closing the transaction and delivering possession to Buyer.

5. By this notice of material defects in need of repair, replacement or correction, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.

5.1 Buyer will close as scheduled or as soon thereafter as any noticed defects have been eliminated by repair, replacement or correction and completion has been verified by Buyer.

THUS:

6. Buyer hereby confirms the condition of the property on the initial inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, **except** for the following itemized material defects in the condition of the property.

6.1 Buyer hereby notifies Seller of the material defects in the condition of the property which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement and makes a demand on Seller to repair, replace or correct the following itemized defects prior to closing:

____
____
____
____
____
____
____
____
____
____
____
____
____.

I agree to the terms stated above.	**Seller hereby acknowledges receipt of a copy.**
Date:_____________, 20______	Date:_____________, 20______
Buyer: ______________________________	Seller: ______________________________
Buyer: ______________________________	Seller: ______________________________

FORM 269 10-07

A Transfer Disclosure Statement completed by the seller and listing agent, without the benefit of a HIR, typically does not accurately or fully reveal the significant property defects or code violations which actually exist, whether or not known to the seller or listing agent.

When the seller has not obtained or refuses to authorize the preparation of a HIR prior to entering into a purchase agreement, the buyer should always order one on opening escrow to confirm the condition of the property before the expiration of any cancellation period.

A buyer should undertake an inspection in the interest of avoiding:

- after-closing discoveries of defects which require correction; and
- after-closing claims he may make against the seller to recover the value lost or the costs incurred to correct the defects.

The buyer's discovery of defects after acceptance of the purchase agreement and **prior to closing**, whether by the buyer's investigation or by the seller's tardy disclosure, does not alter the buyer's right to close escrow, acquire the property and pursue the recovery of costs or the loss of value due to *defects known* to the seller or the listing agent and not disclosed prior to entering into the purchase agreement.

Armed with a HIR containing findings of material defects not known to the buyer or disclosed at the time the purchase agreement was accepted, the buyer can then make the necessary demands on the seller. Thus, the buyer ensures the property will be delivered in the condition **as disclosed** by the seller on entering into the purchase agreement, whether or not a TDS was received prior to acceptance of the buyer's offer.

The buyer's remedies for deceit

If a home inspection report reveals property defects unknown and previously undisclosed to the buyer, the **buyer may**:

- *make a demand* on the seller to correct or eliminate the defects, and refuse to close escrow until the seller has either complied or agreed to an adjusted price [See Form 269];
- *refuse to close escrow* for lack of seller compliance to the demand for corrections and enforce the agreement and its price correction provisions by *specific performance*; or
- *close escrow* and make a money demand on the seller for the difference between the purchase price set in the purchase agreement and the price as adjusted for the undisclosed defects as called for in the purchase agreement. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

If the purchase agreement entered into by the seller and buyer contains a **price adjustment provision**, the buyer can, before closing, enforce a reduction of the purchase price. The price adjustment will be for the amount of the costs necessary to bring the property into the condition as disclosed by the seller or the seller's broker and known to the buyer at the time of acceptance. [See **first tuesday** Form 150 §11.2(b)]

Also, by the seller failing to deliver the property in the condition disclosed prior to acceptance, the seller has failed to convey the property as agreed. Thus, the buyer is justified in refusing to close escrow until the seller compensates the buyer for, or corrects, the defects discovered during escrow.

However, if the buyer is made aware of facts about the condition of the property at the time the buyer enters into the purchase agreement, which would cause an ordinary buyer to be put on notice to investigate into their consequences, the buyer has no grounds for claiming a loss for the condition he knew about.

Final pre-closing inspection

A buyer must personally reinspect the property just before close of escrow to confirm:

- the quality of any repairs made by the seller; and
- the general condition and maintenance of the property after entering into the purchase agreement.

The buyer's right to a final pre-closing inspection of the property is agreed to in the purchase agreement. [See **first tuesday** Form 150 §11.3(b)]

On final inspection of the property, the buyer lists any property defects not already addressed, such as equipment and fixture malfunctions or deferred maintenance, on the final walk-through inspection statement. [See **first tuesday** Form 270]

Chapter 14 — Natural hazard disclosures by the listing agent

This chapter demonstrates the use of the Natural Hazard Disclosure (NHD) Statement by sellers and listing agents to fulfill their obligations to inform prospective buyers.

A unified disclosure for all sales

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects of the property. Locations where a property might be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [Calif. Civil Code §1103(c)]

The existence of a hazard due to the geographic location of a property affects its value and desirability to prospective buyers. Hazards, by their nature, limit a buyer's ability to develop the property, obtain insurance or receive disaster relief.

Whether a seller markets his property himself or lists the property with a broker, the seller must disclose to prospective buyers any natural hazards **known to the seller**, as well as those contained in **public records**.

To unify and streamline the disclosure by a seller (and his listing agent) about those natural hazards which affect a property, the California legislature created a statutory form entitled the *Natural Hazard Disclosure (NHD) Statement*.

The NHD form is used by a seller and his listing agent for their preparation (or acknowledgement of their review of a report prepared by an NHD expert) and disclosure of natural hazard information. The information is both known to the seller and listing agent (and the NHD expert) and available to them as shown on maps in the public records of the local planning department. [CC §1103.2; see Form 314 accompanying this chapter]

Actual use of the NHD Statement by sellers and their agents is **mandated** on the sale of **one-to-four unit residential properties**, called *targeted properties*. Some sellers of targeted properties are excluded from mandatory use of the form, but never their listing agents. Thus, the form, filled out and signed by the seller (unless excluded) and the listing agent, must be included in listing packages handed to prospective buyers on every one-to-four unit residential property.

Editor's note — Any attempt by a seller or listing agent to use an "as-is" provision or otherwise provide for the buyer to agree to waive his right to receive the seller's NHD statement is void as against public policy. [CC §1103(d)]

Regarding excluded sellers and sales of property other than one-to-four unit residential property, use of the statutory NHD Statement by sellers and listing agents is an **optional** method for making their disclosure of natural hazard information to buyers.

NATURAL HAZARD DISCLOSURE STATEMENT

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:_____________, 20______, at____, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ ____

dated ____________, 20______, at ____, California,

entered into by ____, as the ________________________,

regarding real estate referred to as ____

____.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider____ Date ___________

Date:_____________, 20______	Date:_____________, 20______
Seller: ________________________________	Seller's Broker:________________________________
Seller: ________________________________	Agent: ________________________________

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:____ Date:________________

Buyer:____ Date:________________

However, delivery of the information by use of one form or another is not optional. A natural hazard disclosure is **mandated on all types of property**. [CC §1103.1(b)]

All sellers, and any listing or selling agent involved, have an initial common law duty owed to prospective buyers to disclose conditions on or about a property which are **known to them** and might adversely affect the buyer's willingness to buy or influence the price and terms of payment he is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's value and desirability to a prospective buyer. If a hazard is known to any agent (as well as the seller) or noted in public records, it must be disclosed to the prospective buyer before he agrees to purchase the property. If not disclosed, the buyer can cancel the transaction, called *termination*. And if the transaction has closed escrow, the buyer may *rescind* the sale and be **refunded** his investment, called *restoration*. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

Therefore, the need to prepare the seller's NHD statement in advance of locating a prospective buyer **must be anticipated** by the seller and listing agent.

If the need is not anticipated, the NHD will not be prepared, signed and available for delivery to prospective buyers before an offer is accepted or a counteroffer is made, all requisites to delivery of the NHD *as soon as practicable*. [Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Investigating the existence of a hazard

Natural hazard information must be obtained from the *public records*. If not obtained, the seller and listing agent cannot make their required disclosures.

To obtain the natural hazard information for delivery to prospective buyers, the seller and his listing agent are required to exercise *ordinary care* in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. When an expert is employed, he prepares the NHD form for the seller and the listing agent to review, add any comments, sign and deliver to prospective buyers. [CC §1103.4(a)]

Thus, the seller and listing agent may obtain **natural hazard information**:

- directly from the *public records* themselves; or
- by employing a *natural hazard expert*, such as a geologist.

For the seller and the listing agent to rely on an NHD report prepared by others, the listing agent need only:

- **request** a NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology);
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or listing agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and
- **sign** the NHD Statement provided by his NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents. [CC §1103.2(f)(2)]

When prepared by an NHD expert, the NHD report must also note whether the listed property is located within 2 miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*.

The buyer's occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now and later, imposed on the buyer's use as set by the airport's land-use commission. [CC §1103.4(c)]

Also, the expert's report must note whether the property is located within the jurisdiction of the San Francisco Bay conservation and development commission.

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme, while not making the practice mandatory, encourages brokers and their agents to use natural hazard experts rather than gather the information from the local planning department themselves. The use of an expert, who himself relies on the contents of the public record to prepare his report, **relieves** the listing agent of any *liability for errors* not known to the agent to exist.

Neither the seller nor any agent, be he the seller's or the buyer's agent, is liable for the erroneous preparation of a NHD Statement they have delivered to the buyer, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with his professional licensing and expertise; and
- the seller and listing agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

Neither the seller nor the listing agent need enter into an *indemnification agreement* with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for his

errors, not the seller or listing agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if brokers are sued based on the inaccuracy of the expert's report, an indemnity agreement entered into by the expert, given in exchange for the request to prepare a natural hazard report, will cover the cost of any litigation which might unnecessarily haul the broker into court. [See **first tuesday** Form 131]

The listing agent's **dilatory delivery** of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from *liability* for the buyer's lost property value due to the nondisclosure before acceptance. If the agent **knew or should have known** of a natural hazard based on the readily available planning department's parcel list, he is exposed to liability. Liability exposure includes:

- costs the buyer may incur to correct or remedy the undisclosed hazardous condition; and
- the portion of the agreed price which exceeds the property's fair market value based on the undisclosed hazard. [CC §1103.13]

Further, the agents, seller and expert are not exposed to liability from **third parties** to the sale transaction who might receive their erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. Such third parties include insurance companies, lenders, governmental agencies and others who may become affiliated with the transaction. [CC §1103.2(g)]

Documenting compliance with NHD law

Compliance by the seller and listing agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement. [CC §1103.3(b); see **first tuesday** Form 150 §11.5]

However, should the listing agent fail to disclose a natural hazard and then provide in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, his seller is *statutorily penalized*. The buyer, on an in-escrow disclosure, is allowed either a three-day right of cancellation should he be handed the NHD Statement, or a five-day right of cancellation should the NHD Statement be mailed to the buyer. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer, when it could have been previously prepared by the seller or listing agent and timely delivered, imposes liability on the seller and listing agent, but not the buyer's agent. Liability is based on any money losses (including a reduced property value) inflicted on the buyer by the disclosure should the buyer choose not to exercise his right to cancel and instead proceed with the agreement and close escrow. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

Delivery of the NHD to the buyer

It is the **buyer's agent** who has the duty to hand the buyer the NHD Statement the buyer's agent receives from the seller or the listing agent, called *delivery*. [CC §1103.12(a)]

The **buyer's agent**, on receiving the NHD form from the listing agent, owes the buyer a special agency duty to care for and protect his buyer's best interest by reviewing the NHD Statement himself for any disclosure which might affect the property's value or its desirability for his buyer. The buyer's agent is then required to deliver the NHD to the buyer and make any *recommendations or explanations* the buyer's agent may have regarding the consequences of its content. [CC §§1103.2, 1103.12]

If the buyer does not have a broker, the seller's agent is responsible for delivering the NHD Statement to the prospective buyer.

However, the listing agent is not required to understand the effect hazards have on the property or the buyer. Also, the listing agent has absolutely no duty to voluntarily explain to a prospective buyer the effect a known natural hazard (which is itself disclosed) might have on the property or the buyer. The task of explaining the consequence of living with a natural hazard is the duty of a buyer's agent.

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the buyer. [CC §1103.10]

Sellers occasionally act as "For Sale By Owners" (FSBOs) and directly negotiate a sale of their property with buyers in transactions which exclude brokers and agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective buyer.

No warranty, just awareness

A seller's NHD Statement is **not a warranty or guarantee** by the seller or listing agent of the natural hazards affecting the property. The NHD Statement is a report of the seller's and listing agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, the NHD Statement is relied on by prospective buyers. The NHD is designed to assist them in their decisions as to whether they should buy the property, and if they do decide to buy, at what price and on what terms. These conditions all need to exist before entering into a purchase agreement to avoid misleading the buyer, called *deceit*. [AG Opin. 01-406]

Disclosures concerning the value and desirability of a property, such as an NHD Statement, are **price-sensitive information**. Thus, the statement must be delivered to the prospective buyer before he enters into a purchase agreement in order to accomplish their intended result. If not timely disclosed, the seller and listing agent subject themselves to claims for *price adjustments* (offsets) which may be made by the buyer either before or after closing. Alternatively, the buyer may cancel the purchase agreement and have his deposit refunded.

Good brokerage practice would deliver the NHD to the prospective buyer before he makes an offer or accepts a counteroffer, while he is still the prospective buyer. Disclosures should not be delayed until later when the prospect has become the buyer under a purchase agreement and entitled to ownership of the property at the price and on the terms agreed. Properly, the purchase agreement offer would then include a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction is in compliance with NHD law.

As for an **escrow officer** handling a sale in which the listing agent fails to provide the buyer's agent or the buyer with the NHD prior to opening escrow, the escrow officer has no duty to the seller or buyer to prepare, order out or deliver the NHD to the buyer. The obligation remains that of the seller and listing agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the instructions agreed to by the escrow officer. [CC §1103.11]

Excluded sellers, not agents

While all sellers of properties must disclose what is known to them about the natural hazards endemic to a property's location, sellers in some transactions **do not need to use** the mandated NHD form to make their disclosures, such as:

- court-ordered transfers or sales;
- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or a deed-in-lieu;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities. [CC §1103.1(a)]

However, any listing agent involved in an excluded transaction must himself make hazard disclosures, even though he does not need to use the statutory form. [CC §1103.1(b)]

Also, all sellers of any type of property, included or excluded, must, as always, disclose what **they know about any hazards**. Again, the disclosure is best accomplished by use of the NHD Statement on all sales. The NHD expert will definitely include the statement as part of his report. [CC §1103.2(f)(2)]

On properties not mandated to use the form, the listing agent can comply with his and his seller's duty to disclose by ordering a report from a natural hazard expert. On the listing agent's receipt of the expert's report, he will review the report (preferably with the seller), add what they know about hazards which are not included in the expert's report, sign the NHD statement accompanying the report and hand the entire NHD package to prospective buyers before an offer is submitted or a counteroffer made.

Other disclosure statements distinguished

The NHD Statement handed to a prospective buyer of one-to-four unit residential property is an additional disclosure unrelated to the *environmental hazards* and *physical deficiencies* in the soil or improvements located on or about a property as disclosed on the Transfer Disclosure Statement (TDS) or in the purchase agreement. [See **first tuesday** Form 304 §C(1)]

The TDS discloses health risks resulting from **man-made** physical and environmental conditions affecting the use of the property. They are limited to facts known to the seller and listing agent without concern for a review of public records on the property at the planning department or elsewhere. The NHD Statement discloses risks to life and property which exist **in nature** due to the property's location and are known and readily available from the public records (planning department).

Other than one-to-four

Use of the statutory NHD form for hazard disclosures by sellers and their agents is mandated only on the sale of non-exempt, targeted one-to-four unit residential property. [CC §1103]

Thus, sellers and listing agents on all other properties do not need to use and deliver the statutory NHD form to prospective buyers of those properties. However, all sellers and their listing agents still have a duty to disclose hazardous conditions known to them to exist.

Sellers and listing agents of **any type of real estate** must disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and

- a seismic hazard zone. [CC §1103.2]

Even though use of the form is not mandated for sales of property other than one-to-four residential units, agents best meet their hazard disclosure duty in all transactions by using the NHD Statement to convey their knowledge and information contained in public records. [CC §1103.1(b)]

Editor's note — The following discussion details the different hazards which must be disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a *special flood hazard area* and must be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones can come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas can be obtained in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book can be obtained via the web at: http://www.fema.gov/fema/csb.shtm.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: http://msc.fema.gov/.

Another flooding disclosure which must be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services. [Calif. Government Code §8589.5(a)]

Once alerted by the listing agent to the existence of a flooding condition, the buyer's agent must inquire further to learn the significance of the disclosure to the buyer.

Very high fire hazard severity zone

Areas in the state which are subject to significant fire hazards have been identified as *very high fire hazard severity zones*. If a property is located in a very high fire hazard severity zone, a disclosure must be made to the prospective buyer. [See Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Gov C §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the listing agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, if they have an agent.

For example, a buyer occupying a residence located in a very high fire hazard severity zone is advised by his agent that as the new owner, the buyer must, among other things:

- maintain a firebreak around the structure of a distance of no greater than 100 feet, but not past the property line, unless the state or local law requires more; and
- clear dead or dying wood from trees and plants adjacent to or overhanging the structure. [Gov C §51182]

Also, if the property is in a very high fire hazard severity zone or a wildland area, the buyer's agent should inform his client of the possible hardships in obtaining fire or hazard insurance and of the existence of the California Fair Access to Insurance Requirements (FAIR) program which offers a "last-resort" type of policy for properties in these areas. [Calif. Insurance Code §§10095 et seq.]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a *State Fire Responsibility Area*. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating State Fire Responsibility Areas are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county must be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or his listing agent must disclose this fact. If the property is located in a wildland area, it requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see Form 314 §4]

In addition, the NHD Statement advises the prospective buyer of a home located in a **wildland area** that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or listing agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called *Alquist-Priolo Maps*. [Pub Res C §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the listing agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A *Seismic Hazard Zone* map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];
- tsunamis [Pub Res C §2692.1]; and
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement must be marked "Yes." [See Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show Alquist-Priolo Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps which exist are on the web at http://www.conservation.ca.gov/cgs/shzp/Pages/Index.aspx.

If the NHD indicates a seismic hazard, the buyer's agent must then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or see to it that someone else does. The listing agent has no such obligation to the buyer.

For example, property located in Seismic Zone 4 is more susceptible to **strong ground shaking** than areas in Zone 3. But which zone the property is located in is a question the buyer's agent must answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 can be damaged even from earthquakes which occur a great distance away.

Ground failure is a seismic hazard which refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins which are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption or an underwater landslide. Coastal areas are the ones at risk for loss of property and life.

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: http://nctr.pmel.noaa.gov/inundation_mapping.html.

Also, FEMA's Flood Insurance maps consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake causes a dam which serves as a reservoir to rupture. The city or county planning department has maps showing areas which will be flooded if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 15 Structural pest control reports and repairs

This chapter digests the requirements, delivery of, and repercussions of the Structural Pest Control Report.

Pricing and asymmetric information

When a home with wood components goes on the market, the war over the Wood Destroying Pests and Organisms Inspection Report, commonly called a *Structural Pest Control (SPC) Report*, and the repairs begins. As is often the case, custom seems mostly to blame.

First, in one corner is the seller. He will tell the listing agent (and himself) that he has seen neither hide nor hair of anything resembling a termite infestation, so obviously there is no need for either a report or a clearance. And as for repairs, he's all for selling the property in an "as the buyer sees things" condition.

The seller's paladin on this field of battle is his listing agent. Conscientious listing agents will push their sellers to order out the SPC report and fix the repairs now in the name of *transparency*—and an earlier sale.

Armed with a pest control operator's *certificate of clearance*, the listing agent will be better able to get the listing price for the property. Later renegotiations of the sales price due to a delayed, in-escrow disclosure of discoverable material defects (in-fact if not in-law) like wood-destroying infestations and infections is avoided.

Others, of course, would rather do nothing and let sleeping termites lie, just as the sellers want. Thus, the uncertainty of a risk of loss is shifted to the buyer, letting him check out the property to see what he finds.

In the other corner is the prospective buyer. During his observations of the property, he is likely blind to all that moves (like termites/etc.) beneath the surface. He wants to purchase a sound home, but may not know all the right questions to ask, or worse, all the games that the multiple listing service (MLS) gatekeepers have learned to play when working as listing agents on behalf of sellers.

Here, the buyer's champion is his selling agent. It is he who is burdened with the mission of fighting industry-wide **seller bias** by:

- ferreting out the *undisclosed facts known or readily available* to the seller and his listing agent;
- determining the *veracity of the disclosures* they do receive; and
- reviewing a *due diligence checklist* with the buyer to make sure he takes the necessary steps so the buyer's purchase is, among other things, free of termites.

The seller who gets his way

Sellers are occasionally allowed to control the conversation at the listing stage and take a pass on the opportunity to order an SPC report and clearance. When termites are later disclosed to the buyer after acceptance of an offer to purchase, no one wins and ill-will is spread all around.

Consider a SPC report first delivered to the buyer *after* entering into a purchase agreement. It discloses the existence of termites or structural damage due to a termite infestation or a fungi infection which the

buyer was not previously aware of. He was not told about their existence and did not observe termite conditions on the various walk-through reviews of the premises prior to the seller accepting the buyer's purchase agreement offer.

Upon finding out, the buyer feels taken, as no doubt he should. The seller is irritated, either at being found out or at not being properly advised by his agent on the inevitable need for a report. To keep the deal together, the two agents must now engage in testy negotiations over who is to pay for the corrections and the issuance of a certificate of clearance, and resolve an issue that need not have existed in the first place.

The real irritation for the buyer is the concept of **buyer responsibility** fostered by the pest control provisions in the real estate trade association purchase agreement forms.

The provisions require the buyer to consider paying for repairs and clean-up in order to get a certificate of clearance—a contingency in the purchase agreement and required for a Federal Housing Authority (FHA)-insured loan. Pest control issues adversely affect the value of the seller's property and the price the buyer will pay.

In **boom times**, sellers get their way since they can demand top dollar, not disclose property defects until just prior to closing, refuse to correct any of those deficiencies, and, by agreement, force buyers to eat the cost if they are going to finance and buy the property. Using a trade association purchase agreement with such termite provisions places the buyer at a disadvantage.

Worse yet, no *contractual relief* exists for the buyer when the seller knows termites exist before accepting a purchase offer, repairs are needed to obtain a clearance, and the seller refuses the buyer's demands for the seller to get a clearance by removing the termites and their damage.

In **bust times**, such as what we're experiencing now and will most likely continue to experience into 2013, it's the buyers who get all they demand. With full transparency at the marketing stage when the prospective buyer is first exposed to the property instead of a belated disclosure of the defects after the buyer's purchase offer has been accepted, the seller avoids all the in-escrow demands to get the defects repaired, the property maintained, and most importantly, the price reduced for any minor dislikes threatening the close of the deal.

Eliminate the risk

Unlike a Transfer Disclosure Statement (TDS) or a Natural Hazard Disclosure (NHD), an SPC Report is not a required disclosure in a California real estate transaction. However, before lending money on a property the FHA will require:

- an **inspection** to be made by a licensed SPC company;
- an **SPC Report** prepared by the SPC company after the inspection is complete; and
- a subsequent **Pest Control Certification** stating no active infestation or infection exists on the property. [HUD Mortgagee Handbook 4155.2 Ch-4, §5.d]

Most conventional lenders will not require a report or clearance.

However, prudent buyers and selling agents alert to the fact they are duty-bound to act in the best interests of their buyers will demand an SPC inspection, report, and certification by placing a straightforward, simple **SPC contingency provision** in the purchase agreement, regardless of the nature of the buyer's purchase-assist financing. [See **first tuesday** Form 150 §11.1(a)]

Seller's listing agents acting in the best interest of their sellers will urge their sellers to authorize a prompt inspection and report upon taking the listing. The report, or better yet the clearance after all recommended repairs are completed, will be included in the listing agent's marketing package.

Disclosure upfront and before accepting offers promotes the profession's need for transparency in a transaction. Transparency avoids personal liability for withholding information known to the seller or the listing agent from prospective buyers about a material fact, conduct called *deceit*.

When to deliver the SPC report

The existence of termites *adversely affects* the value of property, which is why disclosure is compelled before the buyer enters into a purchase contract and sets the price and closing conditions with the seller.

In a transparent real estate market, the report and clearance would be part of the **marketing package** given to any prospective buyer who seeks more information on the property. A request for further information by a prospective buyer constitutes the commencement of negotiations toward the purchase of a property.

Purchase agreements frequently include SPC provisions in the terms of purchase or as a condition of financing (FHA). When a purchase agreement requires a SPC report, a copy of the SPC report must be **delivered to the prospective buyer** or buyer's selling agent by the seller or his listing agent *as soon as practicable* (ASAP). ASAP means prior to entering into the purchase agreement if the SPC report is available.

However, if for lack of a report it is not possible to hand the prospective buyer the SPC report until after the seller's acceptance of the purchase offer, closing is automatically contingent on the buyer's right to cancel the purchase agreement and escrow instructions. [Calif. Civil Code §1099(a)]

The term "as soon as practicable" actually carries the same meaning as does the term "as soon as possible". Thus, ASAP means an existing termite report will be delivered to the *prospective buyer* when the listing agent involved become aware the buyer is going to submit an offer calling for a SPC report or for (FHA) financing which requires an SPC report.

Should the offer be submitted to the seller without prior indication to the listing agent that the buyer or the lender will require a SPC report, a counteroffer should be made. The counteroffer would deliver the SPC report, and if not available, advise the buyer of the termite information known to the seller or the listing agent. [Calif. Attorney General Opinion 01-406 (August 24, 2001)]

A counteroffer could be used solely for the purpose of making the SPC disclosure, even if no need exists for a change in the terms of the buyer's offer. Disclosure is always most *practicable* before the acceptance occurs—ASAP—to determine if the buyer's knowledge of the contents of a report or other knowledge of the termite conditions causes the buyer to reconsider the price or terms of his offer.

The **failure to disclose** before the seller accepts the buyer's offer is the result of one of two situations:

1. No one knows about the existence of termites or the damage they created because the readily available inspection and report was not ordered and the discovery was not made before the property was put under contract with the buyer. OR
2. The seller or the listing agent resorts to deceit as the existence of a condition which adversely affects value is known to the seller or the listing agent and not disclosed before the seller accepts the buyer's purchase offer.

The second situation is fraudulent and allows the buyer to pursue the seller and the listing broker/agent to recover the **cost of repairs**. Contract provisions in the purchase agreement allowing the seller to entirely avoid the cost of termite clearance and repairs are not enforceable when known defects go undisclosed at the time the buyer goes under contract. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A separated SPC report

The custom brought about by the bifurcated pest control handling through an addendum to purchase agreements supplied by the trade associations causes agents to request the SPC company to prepare a **separated report**. The SPC company is asked to separate their findings and recommendations into two categories:

- **Section I items**, listing items with visible evidence of active infestations, infections, or conditions that have resulted in or from infestation or infection; and
- **Section II items**, listing conditions deemed likely to lead to infestation or infection but where no visible evidence of infestation or infection was found.

However, sellers need to order the inspection and report when the property is listed so any necessary repairs will become known, the cost for any correction ascertained, and any repairs completed before a prospective buyer is located. Misrepresentations of the property's condition cannot then become surprises during escrow. On the other hand, it is the intention of some sellers to contract for the buyer to be responsible for the structural pest control clearance, a situation which easily leads to nondisclosure.

These "defective" conditions of termites and their damage to the property are owned by the seller. In a bust market, the buyer with a selling agent whose duty of care it is to protect his buyer is not about to let the seller pass any sort of deficiency which adversely affects the value of the property onto the buyer.

Thus, requesting a separated report in the current climate is misdirected since the intent of a separated report is to divide: divide the type of conditions, and more importantly, to shift the responsibility which is the seller's alone to an unsuspecting buyer.

More to the point, why risk having prospective buyers walk away from your listing, especially in a buyer's market, just because a termite-free home with a clearance and certainty of risk is available around the corner to the risk-averse buyer?

A certificate of clearance

An active termite infestation or fungus infection is occasionally found on an inspection prior to marketing the property. The seller then needs to consider taking corrective measures to both protect the property from further damage and ready it for a prospective buyer by eliminating the issue of termites.

A **Pest Control Certification**, a statement by the SPC company indicating the property is free of infestation or infection in the visible and accessible areas, will then be issued. This certification is commonly called a termite clearance. However, if any signs of infestation or infection *have not been corrected*, it will be noted in the certification. [Calif. Business and Professions Code §8519]

The FHA when insuring a loan only requires a certificate of clearance stating that Section 1 items have been corrected. However, any Section 2 conditions which may lead to future infestations or infections will be noted on the Pest Control Clearance so the SPC company will not be liable for the costs incurred to eliminate those conditions. Section 2 conditions usually are only observed in homes that do not have a slab foundation and have a crawl space beneath the floor of the structure. [Bus & P C §§8516(d), 8519]

What and when to disclose

Consider a one-to-four unit residential property of wood frame construction listed with a broker who is employed to locate a buyer.

The listing agent explains he wants the seller to order an SPC inspection and report now since any prospective buyer (or his FHA lender) will want an SPC Report and Pest Control Certification before escrow can close.

The listing agent receives **written authorization** from the seller and orders an inspection and separated report from an SPC company known to the listing agent to be competent and diligent. [See **first tuesday** Form 132]

The inspection report received from the SPC company states conditions exist which will likely lead to an active termite infestation (Section II items) and recommends repairs and further inspection into inaccessible areas.

Unhappy with the report and the estimated cost of repairs, the seller has the listing agent get a second opinion from a different SPC company.

The second company states there is an active termite infestation (a Section I item) and lists estimates for repair which are higher than the first company's estimates.

A buyer is located for the property. Deciding to go with the first SPC company's report, the seller completes the repairs recommended by the first company. The listing agent delivers a copy of the first company's inspection report to the buyer (or buyer's selling agent), but does not inform the buyer or his agent of the second inspection report.

Escrow closes and the buyer moves in. The buyer discovers termites and the existence of the second inspection report. The buyer, after paying for extensive repairs and corrective measures, makes a demand on the listing agent for his costs to correct the damage, claiming the listing agent was liable since he knew about the second report and the termite infestation, a material fact he did not disclose.

Is the listing agent liable for the costs the buyer incurred to cure the termite damage since he knew about the second report and the termite damage and failed to disclose the report or its contents?

Yes! The second report stated an active infestation existed which is a material fact requiring disclosure since the condition adversely affected the value and desirability of the property. The seller's agent is responsible to ensure the delivery of all known inspection reports to a buyer. The seller's agent cannot pick and choose which reports to deliver. [**Godfrey** v. **Steinpress** (1982) 128 CA3d 154; Department of Real Estate Bulletin, Summer 2004]

Choosing the right company

When choosing an SPC company, the listing agent needs to protect his client and verify the individual or company's license, the company's registration, and the individual's or company's complaint history by calling the SPC Board at 916-561-8708 (in Sacramento) or 800-737-8188 ext. 2 (outside Sacramento), or at www.pestboard.ca.gov.

The Board maintains a two-year history of complaints against every SPC company and information on the company's bond and insurance. [Bus & P C §8621]

Every company registered with the SPC Board must maintain a $4,000 bond. The bonds are in favor of the State of California for the benefit of any person who, after entering into a contract with a registered, licensed company, is damaged by:

- fraud; or
- dishonesty. [Bus & P C §§8697, 8697.2]

Further, the bonds also protect any person who is damaged as a result of any violation of the SPC Act by a registered and licensed SPC company.

Each company must also have general liability insurance with a minimum of:

- $25,000 for bodily injury; and
- $25,000 for property damage per loss.

The general liability insurance covers financial loss due to:

- property damage;
- public injury; and/or
- illness as a result of the company's actions.

The original inspection and report

The individual or company who does the inspection and issues the report must hold a Branch 3 Wood-Destroying Pest and Organisms License/Registration. Only those with a **Branch 3 license** may:

- **perform inspections** for wood-destroying pests and organisms;
- **issue inspection reports** and completion notices;
- **conduct treatments**; and
- **perform any repairs** recommended on the inspection report.

An inspection will cover all *accessible areas* to determine whether an active infestation or infection exists or if conditions which will likely lead to future infestations or infections exists. *Inaccessible areas* do not need to be covered in an inspection.

An area is considered **inaccessible** if it cannot be inspected without opening the structure or removing the objects blocking the opening. Examples of inaccessible areas are:

- attics or areas without adequate crawl space;
- slab foundations without openings to bathroom plumbing;
- floors covered by carpeting;
- wall interiors; and
- locked storage areas.

All SPC companies use a **standardized inspection report** form. An inspection report includes:

- the inspection date and the name of the licensee making the inspection;
- the name and address of the person ordering the report;
- the name and address of any party in interest;
- the address or location of the property;
- a general description of the building or premises inspected;
- a diagram detailing every part of the property checked for infestation or infections;

- a notation on the diagram of the location of any wood-destroying pests (termites, wood-boring beetles, etc.) or fungus present, and any resulting structural damage visible and accessible on the date of inspection, called *Section 1 items* if a separated report is requested;
- a notation on the diagram of the location of any conditions (excessive moisture, earth-to-wood contact, faulty grade levels, etc.) considered likely to lead to future wood-destroying pest infestations or infections, called *Section 2 items* if a separated report is requested;
- one of the following statements:
  - **"The exterior surface of the roof was not inspected. If you want the water tightness of the roof determined, you should contact a roofing contractor who is licensed by the Contractors' State License Board."**
  - **"The exterior surface of the roof was inspected to determine whether or not wood destroying pests or organisms are present."**
- a statement of which areas have not been inspected due to inaccessibility with recommendations for further inspection of these areas if practicable;
- recommendations for treatment or repair;
- information regarding the pesticide(s) to be used, if necessary;
- that a reinspection will be performed if an estimate for making repairs is requested by the person ordering the original report; and
- the following bold-type statement:
  - **"NOTICE: Reports on this structure prepared by various registered companies should list the same findings (i.e., termite infestations, termite damage, fungus damage, etc.). However, recommendations to correct these findings may vary from company to company. You have a right to seek a second opinion from another company."** [Bus & P C §8516(b); 16 Calif. Code of Regulations §1990]

Further, the following statement must appear prior to the first finding/recommendation on a separated report:

- "This is a separated report which is defined as Section I/Section II conditions evident on the date of the inspection. Section I contains items where there is visible evidence of active infestation, infection or conditions that have resulted in or from infestation or infection. Section II items are conditions deemed likely to lead to infestation or infection but where no visible evidence of such was found. Further inspection items are defined as recommendations to inspect area(s) which during the original inspection did not allow the inspector access to complete the inspection and cannot be defined as Section I or Section II."

The company chosen must furnish the person who ordered the inspection a copy of the report within 10 business days of the inspection. [Bus & P C §8516(b)]

All original inspection reports must be maintained by the SPC company for three years. [Bus & P C §8516(b)]

All SPC companies must post an **inspection** tag in the attic, subarea, or garage on completion of an inspection. The tag must give the company's name and the date of inspection. [16 CCR §1996.1]

Reinspections for corrections made

If an estimate for corrective work is not given in the original inspection report or thereafter, then the company is not required to perform a reinspection. A reinspection will be required if a separated report

is requested as an estimate for repairs must be given separately allocating the costs to perform each and every recommendation for corrective measures for Section I and II items.

The **reinspection** is to be performed within 10 days of it being requested. A simple reinspection and certification will occur at that time. However, if more than **four months have passed** since the original inspection and report, a reinspection will not suffice. A full (original) inspection must be completed and a new (original) inspection report must be issued. [Bus & P C §8516(b); 16 CCR §1993]

Work Completion and Certifications

The person who ordered the report is never required to hire the SPC company chosen to inspect the property to also complete any corrective measures. For instance, a second SPC company can be called in to work on the structure. However, this second company will need to send a Branch 3 licensee to inspect the property since they may not rely on the report furnished by the original SPC company to perform repair work. [Bus & P C §8516(b); **Pestmaster Services, Inc.** v. **Structural Pest Control Board** (1991) 227 CA3d 903]

Further, the owner may not want to use a SPC company to perform the **corrective work**. Here, the owner may hire a licensed contractor to remove and replace a structure damaged by wood-destroying pests or organisms the work is incidental to other work being performed or is identified by an SPC inspection report. A licensed contractor cannot perform any work that requires an SPC license to complete. [Bus & P C §8556]

However, if the original SPC company gives an estimate or makes a bid to undertake corrective measures and the owner hires someone else to perform the corrective measures, the original SPC company must *return and reinspect* the property before issuing a certification. The original SPC company will not certify treatments performed by another SPC company without reinspection. [Bus & P C §8516(b)]

An SPC company is required to prepare a **Notice of Work Completed and Not Completed** for any work they undertake on a structure. The notice is given to the owner or the owner's agent within 10 working days after completing any work. The notice includes a statement of the cost of the completed work and the estimated cost of any work not completed. A copy of the Notice of Work Completed and Not Completed is delivered by the seller or seller's agent to the buyer or buyer's selling agent as soon as practicable. [Bus & P C §8518; 16 CCR §1996.2; CC §1099(b)]

If the property is fumigated, the fumigation company (which must hold a Branch 1 license) will issue a certification of fumigation within five days.

After any SPC company completes treatment or repairs, a **completion tag** must be placed next to the inspection tag. The completion tag must display:

- the name of the company;
- the date of completion; and
- the name of any chemicals used. [Bus & P C §8518; 16 CCR §1996.1]

An SPC company is only required to certify its inspection and repair work if requested by the person ordering the report. The company, after completing the inspection or work, will **certify upon request** that:

- the inspection disclosed no evidence of active infestations or infections in the visible and accessible areas;
- the inspection disclosed evidence of active infestations or infections and that they have been corrected; or
- the property is free of active infestations or infections in the visible and accessible areas.

Teaching your seller to "own it"

In a buyer's market and the years immediately following, listing agents are going to need to school their sellers on what a buyer will and will not tolerate. When it comes to the SPC inspection, report, repair, and certification, they all initially belong to the seller. Further, the obligation usually remains with the seller since no buyer's agent worth his salt is going to allow his buyer to purchase termites or their breeding grounds.

In a seller's market, a seller may be able to make a buyer pay for the seller's termite problem, leave conditions that may lead to future infestations and infections unfixed, and still command a price at a multiple of the amount they paid for the property. Those days are over for the foreseeable future.

Listing brokers and agents need to make sure sellers understand that if they don't want to continue "owning" the termites (and the property), they need to fix and maintain the property in a marketable condition. If not, they must be prepared to fight over the price they want for their home, and most likely lose that battle.

Chapter 16 Environmental hazards and annoyances

This chapter presents the environmental conditions located on or in the vicinity of a property which adversely affect occupants of the property due to their injurious effect on the health or sensitivities of humans.

Noxious man-made hazards

Environmental hazards are noxious or annoying conditions which are **man-made hazards**, not natural hazards. As **environmental hazards**, the conditions are classified as either:

- *injurious* to the health of humans; or
- an *interference* with an individual's sensitivities.

In further analysis, environmental hazards are either located on the property or originate from sources located elsewhere which affect the occupant in his **use and enjoyment** of the property.

Environmental hazards **located on the property** which pose a direct health threat on occupants due to construction materials, the design of the construction, the soil or its location, include:

- *asbestos-containing* building materials and products used for insulation, fire protection and the strengthening of materials [Calif. Health and Safety Code §§25915 et seq.];
- *formaldehyde* used in the composition of construction materials [Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1];
- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium [CC §2079.7(a); Bus & P C §10084.1];
- *hazardous waste* from materials, products or substances which are **toxic**, **corrosive**, **ignitable** or **reactive** [Health & S C §25359.7; Bus & P C §10084.1];
- *toxic mold* [Health & S C §§26140, 26147];
- *smoke* from the combustion of materials, products, supplies or substances located on or within the building [Health & S C §§13113.7, 13113.8];
- *security bars* which might interfere with an occupant's ability to exit a room in order to avoid another hazard, such as a fire [CC §1102.16; Health & S C §13113.9]; and
- *lead*. [See Chapter 15]

Environmental hazards **located off the property**, but which have an adverse effect on the use of the property due to noise, vibrations, odors or some other ability to inflict harm, include:

- *military ordnance* sites within one mile of the property [CC §1102.15];
- *industrial zoning* in the neighborhood of the property [CC §1102.17];
- *airport influence* areas established by local airport land commissions [CC §§1103.4(c), 1353; Bus & P C §11010(b)(13)]; and
- *ground transportation* arteries which include train tracks and major highways in close proximity to the property.

The effect on value and desirability

Environmental hazards have an *adverse effect* on a property's value and desirability. Thus, they are considered defects which, if known, must be disclosed as *material facts* since the hazards might affect a prospective buyer's decision to purchase the property.

The disclosure of a seller's and listing agent's knowledge of existing environmental hazards is required on the sale, exchange or lease of all types of property.

While the disclosure of an environmental hazard is the obligation of the seller, it is the listing agent who has the agency duty of care and protection owing to his seller to place the seller in compliance with the environmental hazard disclosure requirements.

Further, and more critically, the listing agent also has an additional, more limited duty owed to prospective buyers of the listed property. The listing agent must personally conduct a **visual inspection** of the property for environmental hazards (as well as physical defects), and do so with competence. Then the listing agent by use of the TDS must advise prospective buyers of his observations (and knowledge) about conditions which constitute environmental hazards. [CC §2079]

To conclude the listing agent's disclosure of environmental hazards and eliminate any further duty to advise the prospective buyer about the environmental hazards, the listing agent delivers, or confirms the buyer's agent has delivered, a copy of the **environmental hazard booklet** approved by the California Department of Health and Safety (DHS) to the buyer. Delivery of the booklet is confirmed in writing by use of a provision in the purchase agreement. [See **first tuesday** Form 150 §11.6; see **first tuesday** Form 316-1, also available at *www.firsttuesday.us*]

However, the listing agent might be subjected to an inquiry by either the prospective buyer or the buyer's agent about environmental hazards on or about the property. Here, the listing agent is duty bound to respond fully and honestly to the inquiry.

Method of disclosure

The notice of any environmental hazard to be delivered to a buyer by a seller must be given in writing. No special form exists for giving the buyer notice of environmental hazards, as is provided for natural hazards. Until the real estate industry or the legislature develops one, the Transfer Disclosure Statement (TDS) and the purchase agreement are currently used as the vehicles for written delivery.

Some environmental hazards are the subject of provisions in the TDS, such as a direct reference to hazardous construction materials and waste, window security bars and release mechanisms, and an indirect reference to environmental noise. [See **first tuesday** Form 304 §§A and C]

All other known environmental hazards can be separately itemized in the TDS. As for environmental hazards emanating from off-site locations, they can be disclosed through provisions in the purchase agreement. [See Form 150 §11.7]

*Editor's note — The environmental hazard booklet is not a disclosure of known defects on the property. The booklet merely contains general information on a few environmental hazards, none of which might actually exist on the property. It is voluntarily delivered to the buyer by an agent, but with no legal mandate to do so. [See **first tuesday** Form 316-1]*

Regardless of the vehicle of delivery, the seller's agent is to give the environmental hazard disclosures to the prospective buyer as soon as *practicable*, meaning **as soon as reasonably possible**. As with the dis-

closure of natural hazards, the legislature intended for the environmental hazard disclosures to be made prior to entry into a purchase agreement. [Attorney General Opinion 01-406 (August 24, 2001)]

Need and motivation for disclosure

For the listing agent to properly anticipate the need to have the disclosures available to deliver to prospective buyers, the effort to promptly gather the information from the seller begins at the moment the listing is solicited and negotiated.

The seller and the listing agent have numerous good reasons to fully comply at the **earliest moment** with the environmental hazard disclosures (as well as all other property-related disclosures). The **benefits of a full disclosure**, upfront and before the seller accepts an offer or makes a counteroffer, include:

- the prevention of delays in closing;
- the avoidance of cancellations on discovery under due diligence investigation contingencies;
- the elimination of having to renegotiate the price or offset corrective costs due to the listing agent's dilatory disclosure or the buyer's discovery during escrow;
- the shortening of the time needed for the buyer to complete his due diligence investigation; and
- control by the seller of remedial costs and responsibilities by terms included in the purchase agreement, not by later offsets or demands by the buyer or a court.

The listing agent needs to document in writing (for his file only) the agent's inquiry of the seller about environmental hazards which are known or should be known to the seller. The agent's list should itemize

- all the environmental hazards which might possibly exist on or about a property and the construction materials which contain them;
- the age or date of construction to elicit a review of probable hazardous construction materials used at the time of construction; and
- information known about the property on disclosures the seller received when he purchased the property or were brought to his attention on any renovation of the property.

Also, the listing agent's inquiry into hazardous materials should precede the seller's preparation of the TDS. Thus, the seller is mentally prepared to release information about his knowledge of defects in the condition of the property. Finally, the listing agent's visual inspection should also be conducted before the seller prepares his TDS so his observations may be discussed.

The seller has **no obligation to hire an expert** to investigate and report on whether an environmental hazard is present on or about the property. The seller is also not obligated to remove, eliminate or mitigate an environmental hazard, unless he becomes obligated under the terms of his purchase agreement with the buyer.

It is the seller's and his listing agent's knowledge about the property which is disclosed on the TDS. The off-site environmental hazards which affect the use of the property are generally well known by the buyer's agent for inclusion in the purchase agreement. If not included in the TDS or the purchase agreement, a counteroffer by the seller is necessary to disclose — as soon as practicable — the seller's and the listing agent's knowledge of environmental hazards located both on and off the property.

Asbestos in construction materials

Asbestos is any of a diverse variety of *fibrous mineral silicates* which are commercially mined from natural deposits in the earth. In the 1940's manufacturers began mixing asbestos fibers with substances commonly used to produce materials for the construction of residential and non-residential real estate

improvements, such as cement, plastic, stucco, vinyl, insulation and felt roofing materials. Asbestos fibers added greater tensile strength, insulation qualities and fire protection to the construction materials which included them. [Health & S C §25925]

However, asbestos is a known *carcinogen*. As an occupant of a building continues to inhale asbestos fiber, he increases his risk of developing cancer of the stomach and chest lining (mesothelioma), asbestosis of the lungs, and lung cancer.

Construction materials which contain **friable asbestos** are those that can be crumbled, pulverized or reduced to powder by hand pressure when dry. Examples of friable material include:

- the acoustic popcorn ceilings homes, apartments and offices;
- thermal insulation on pipes and hot water heaters;
- wall texturing compounds; and
- sheet rock joint compounds, called "mud."

Construction materials which contain **non-friable asbestos** cannot be crushed by hand pressure. Examples of non-friable material include vinyl, asphalt or cement items, such as stucco plaster, vinyl tiles and asphalt roofing felts. Of course, on the removal of stucco or plaster, the asbestos may **become friable** since the material is disturbed and broken down for removal, creating particles which may become airborne and inhaled.

Asbestos is only harmful to humans when the fibers are inhaled and accumulate in the lungs producing, over time and with continuous exposure, an increased risk of cancer.

Thus, asbestos-containing material used in the construction of a building is best left undisturbed by avoiding renovation or demolition. If the material is in good condition (not crumbling or deteriorating), it is best to leave it in place when redecorating or renovating a property.

The seller of a property constructed with asbestos-containing building materials is under no obligation to investigate or have a survey conducted to determine the existence of asbestos on the property — whether friable or non-friable.

Further, the seller is not obligated to remove or clean up any adverse asbestos condition. However, the condition **must be disclosed**. As a result, a prospective buyer may well condition the purchase of a property containing friable asbestos on its clean up and removal by the seller.

Asbestos fibers have not been used in molded thermal insulation material in spray applications for textured ceilings since 1978.

From 1940 to 1996, some homes were built with materials containing asbestos mixed with other components, such as vinyl floor tiles, backings for linoleum, HVAC duct wrapping, hot water pipe insulation, cement siding and pipes, stucco, plaster, asphalt roofing felts, ceiling and wall insulation, and taping compounds. Any removal of these components requires notification to the local air quality management district and the use of a registered contractor.

Formaldehyde gas emissions

Formaldehyde is a colorless, pungent gas contained in most organic solvents which are used in paints, plastics, resins, pressed-wood fiberboard materials, urea-formaldehyde foam insulation (UFFI), curtains and upholstery textiles. Gas emitted from these materials and products contains formaldehyde.

Formaldehyde is considered a *probable carcinogen* which is likely to cause cancer in humans who inhale the gas emitted by formaldehyde-containing material.

The use of UFFI occurred in construction during the 1970s and was banned in residential property constructed after 1982. However, formaldehyde emissions decrease over time. As a result, properties built during the 1970s and early 1980s with formaldehyde-containing materials give off levels of formaldehyde no greater than newly constructed homes. Over time, emissions decrease to undetectable levels. However, an increase in humidity and temperature will increase the level of emissions.

Radon gas in the soil

Radon is a naturally-occurring radioactive gas. It is not visible, cannot be tasted and has no odor. Detection is by instruments only. Radon gas is located in soils with a concentration of uranium in the rock, e.g., granite or shale, beneath it.

Radon is a known human *carcinogen*. The health risk for humans is lung cancer. For smokers, the risk of cancer is substantially increased by radon gas exposure.

Radon gas enters a building from the soil beneath the structure, be it a home, apartment building or non-residential improvement. Cracks and openings for plumbing in concrete slabs and the porous nature of concrete block basement walls allow the gas from the soil to enter space at or below ground level. Thus, radon is rare in buildings of two or more floors in elevation, except for the ground floor and underground areas.

Radon is sucked into ground floor residential space by interior heating on cold weather days and the use of exhaust fans in the kitchen and bathrooms since these conditions create a vacuum within the lower area of the structure.

However, California residences rarely experience elevated and harmful levels of radon gas emission. Radon does appear in approximately **one percent of housing** in California. Proper ventilation avoids the build up of harmful concentrations of radon in a home or other enclosed space, a function of its design and operation.

Hazardous waste on site

Waste is hazardous if it has the potential to harm human health or the environment. Hazardous waste is released into the environment, primarily the soil, by the leaking of underground storage tanks, drum containers, poorly contained landfills or ponds, accidental spills or illegal dumping.

Hazardous waste materials include any product, material or substance which are *toxic, corrosive, ignitable or reactive*, such as is generated by oil, gas, petrochemical and electronics industries, and dry cleaner and print shops.

Information is available to prospective buyers on their inquiry into the location and status of hazardous waste sites in the vicinity of a home from the “Cortese list” maintained by the California Environmental Protection Agency (EPA).

Mold: the rogue presently in vogue

Mold produces spores which become airborne. The spores are inhaled by humans who enter or occupy the space within the area generating the spores. There are many different kinds of spores, each having

differing effects, if any, on humans. Some may be a mere annoyance, irritating the sensitivities of an individual. Others might be a threat to the health of those who inhale them.

The uncertainty of the toxic nature of mold spores has lead to a sort of intellectual moratorium on determining just what kinds of molds have an adverse or harmful effect on humans.

It has also spawned a number of lawsuits as the unknown nature of "toxic mold" has been allowed by politicians and lawyers to stir the fears of the general public.

Consider an inspection of a residential unit with conditions conducive to mold (prior dampness) which reveals the presence of mold, including an insignificant amount of *toxic mold* varieties.

The tenant occupying the unit goes to a doctor after suffering from a range of health problems. The doctor, on review of the mold report, attributes the ailments to the existence of toxic mold in the unit.

A second inspection is ordered which confirms the first inspection; the preponderance of the mold present is non-toxic and the amount of toxic mold found is typical of normal conditions and is of a level which does not contribute to health problems.

The tenant seeks compensation for his health problems, claiming the landlord neglected his duty to provide a healthful environment since he allowed the development of mold which the doctor says led to the tenant's health issues.

Based on the insignificant amount of toxic mold, is the landlord liable for the tenant's illness?

No! The insignificant amount of toxic mold existing in the unit and the doctor's conclusion that the tenant's health problems are connected to toxic mold do not justify holding the landlord liable. [**Dee** v. **PCS Property Management, Inc.** (May 11, 2009) __CA4th___]

Editor's note—The holding of the ***Dee*** *case is apparent from the first line of the opinion, which made it clear that mold is everywhere, in every breath we breathe.*

Sellers are, of course, under no obligation to investigate whether the improvements contain mold. If it is known the structure does contain mold, the seller has no obligation to determine if the mold is a threat to human health.

The DHS has not yet set any **standards** for disclosures regarding the existence of mold. **Guidelines** for the remediation of mold threats and the approval and distribution of a **consumer-oriented booklet** on mold have also not yet been created by the DHS.

Until disclosure standards are produced, the prospective buyer will, at best, receive a writing from the seller and the listing agent in the form of a TDS advising the buyer of any awareness or knowledge the seller or the listing agent may have that mold exists on the property. No common knowledge exists for sellers or listing agents to visually distinguish between harmful and benign molds.

The DHS has not and presently has no expectations as to when they will release these standards, guidelines and booklet to inform prospective buyers about any harmful molds. These rules will set the permissible exposure limits for humans to various molds and identify those molds which pose a health threat to humans.

If the seller is aware of mold, regardless of type, he is to disclose his awareness of the mold's existence, as well as any other reports or knowledge he (or his agents) have about the variety of mold which exists.

To produce mold standards, guidelines and the consumer-oriented booklet, the DHS must first assemble a panel of advisors as a **task force** to investigate, review and recommend the content of the standards, guidelines and booklet. But before assembling the task force, the program must be funded ($900,000 plus, and funding has not occurred as of June 30, 2009), a cost which is far less than the costs of litigation brought about by the uncertainties of not having standards and guidelines. [Dee, *supra*]

The DHS anticipates that once the task force is selected, recommendations will not be forthcoming for two additional years. Then, the standards, guidelines and booklet produced by the task force must be adopted or approved by the DHS.

When the DHS does finally act to adopt or approve the rules and booklet, they will not become effective for an additional six to twelve months. Thus, no disclosure based on guidance from the state will likely be available to brokers, agents and sellers to deliver to buyers until well after 2012.

Chapter 17 Lead-based paint disclosures

This chapter evaluates the lead-based paint hazard disclosure mandatory on the sale of all residential housing built prior to 1978 and the risks of accepting a buyer's purchase agreement offer before disclosure.

Crystal clear transparency

An agent, while soliciting an owner of a residential property to employ the agent's broker to market and locate a buyer for the property, gathers facts about the property, its ownership and its likely market value.

The property profile furnished by a title company confirms the agent's suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of lead-based paint.

The agent sets up a meeting with the owner to review the requisite listing and marketing requirements laid down by his broker, and the owner's expectations for a listing price and an acceptable sales price. To prepare for the meeting, the agent fills out the listing agreement and attaches all the disclosure forms needed to correctly market and sell the property, called a *listing package*.

Among other informational forms, the agent includes two forms which address **lead-based paint conditions** on the property:

- the Federal Lead-based Paint (LBP) disclosure [See Form 313 accompanying this chapter]; and
- the California Transfer Disclosure Statement (TDS). [See Form 304 accompanying Chapter 11]

At the presentation of the listing agreement, the agent explains the **seller's legal obligation**, owed to prospective buyers and their agents, to provide them with all the information known to the owner or known or readily available on an inquiry by the listing agent which might adversely affect the property and its value.

By making the transaction **fully transparent** to prospective buyers from the outset of negotiations, the renegotiation of the purchase agreement, including a demand for a price reduction, cancellation or refund after closing due to further disclosures, is avoided. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A full disclosure to the prospective buyer about the property by the seller and the listing agent does not entail a review or explanation of the facts disclosed. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the listing agent's duties of affirmative disclosure.

However, federal LBP rules do require the listing agent to advise the seller of the seller's pre-purchase agreement disclosure requirements. The listing agent must **insure compliance** by or on behalf of the seller before the seller enters into a purchase agreement.

Editor's note — Regarding the LBP disclosures, the owner is properly informed he has no obligation to have his property inspected and have a report prepared on the presence of lead-based paint or any lead-based paint hazards. Also, the owner is advised he does not have to perform any ***corrective work*** *to clean*

up or even eliminate the conditions, unless he agrees with the buyer to do so. [24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)]

Thus, the seller needs to cooperate in the LBP disclosure and his agent's marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction [See Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See Form 304];
- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and
- providing the listing agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

Lead-based paint and hazards

Lead-based paint, defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was **banned** by the Federal Consumer Product Safety Commission in 1978. [24 CFR §35.86; 40 CFR §745.103]

A **lead-based paint hazard** is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the National Lead Information Center at (800) 424-LEAD. Lists are also available on the web at http://www.leadlisting.com/lead.html and http://www.dhs.ca.gov/childlead.

LBP disclosure content

The **LBP disclosure** form includes the following:

- the *Lead Warning Statement* as written in federal regulations [See Form 313 §1];
- the seller's statement *disclosing the presence* of known lead-based paint hazards or the seller's lack of any knowledge of existing lead-based paint [See Form 313 §2];
- a *list of records or reports* available to the seller which indicates a presence or lack of lead-based paint, which have been handed to the listing agent [See Form 313 §2.2];
- the buyer's statement *acknowledging receipt* of the LBP disclosure, any other information available to the seller and the lead hazard information pamphlet entitled *Protect Your Family From Lead in Your Home* [See Form 313 §3.1; see **first tuesday** Form 316-1];
- the buyer's statement acknowledging the buyer has received a 10-day *opportunity to inspect* the property or has agreed to reduce or waive the inspection period [See Form 313 §3.2];
- the listing agent's statement noting the seller has been informed of the seller's disclosure requirements and that the agent is aware of his *duty to ensure* the seller complies with the requirements [See Form 313 §4]; and
- the *signatures* of the seller, buyer and listing agent. [24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)]

The seller and the listing broker must each keep a copy of the disclosure statement for at least three years from the date the sale is completed. [24 CFR §35.92(c); 40 CFR §745.113(c)]

LEAD-BASED PAINT DISCLOSURE

On Sale of Real Estate

NOTE: For use on the sale of any residential property which was constructed pre-1978.

PROPERTY ADDRESS: ____

Items left blank or unchecked are not applicable.

1. Lead Warning:

1.1 Every Buyer of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women.

1.2 Seller of any interest in residential property is required to provide Buyer with any information on lead-based paint hazards from risk assessments or inspections in Seller's possession and notify Buyer of any known lead-based paint hazards.

1.3 A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

2. Seller's Certification:

2.1 Presence of lead-based paint and/or lead-based paint hazards

a. ☐ are known to be present in the housing as explained: ______________________
____
____.

b. ☐ are not known to Seller to be present in the housing.

2.2 Records and reports available to Seller

a. ☐ Seller has provided Buyer with all available records and reports listed below pertaining to lead-based paint and/or lead-based paint hazards in the housing: ______________________
____
____

b. ☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date: ____________, 20_____ **Seller:** ______________________________

Date: ____________, 20_____ **Seller:** ______________________________

3. Buyer's Acknowlegement:

3.1 Buyer has received:

a. ☐ Copies of all information listed above.

b. ☐ The pamphlet *Protect Your Family From Lead in Your Home*.

3.2 Buyer:

a. ☐ Will receive a ☐ 10-day, or ☐ ______-day, opportunity from acceptance of the purchase offer to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

b. ☐ Waives the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

3.3 I acknowledge that I have read and understood the attached lead warning statement in Section 1 of this form and received all information noted in Section 2 of this form.

Date: ____________, 20_____ **Buyer:** ______________________________

Date: ____________, 20_____ **Buyer:** ______________________________

4. Broker's Certification (When Applicable):

4.1 Broker certifies to have informed Seller of his/her obligation under 42 U.S.C. §4852d to disclose to Buyer and Broker all information known to Seller regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to Broker regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to Buyer.

4.2 Broker further certifies that Buyer has received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home* and that Buyer has or will be given a 10 calendar day period (unless otherwise agreed in writing) to conduct a risk assessment or inspection for the presence of lead-based paint before becoming obligated under the contract to purchase the housing.

Date: ____________, 20_____ **Broker:** ______________________________

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Whether or not the LBP disclosure form is retained does not have an effect on the statute of limitations for the buyer to pursue misrepresentations or alter the buyer's right to post-contract disclosures. [24 CFR §35.92(c)(2); 40 CFR §745.113(c)(2)]

Also, the disclosure form must be in the language of the purchase agreement. For example, if the purchase agreement is in Spanish, then the LBP disclosure must also be in Spanish. [24 CFR §35.92(a); 40 CFR §745.113(a)]

Opportunity to evaluate risk

A prospective buyer must be notified before he makes an offer that he has the opportunity, by way of a **10-day period** after acceptance, to evaluate the hazardous risks involved due to the presence of lead-based paint in residential housing built prior to 1978. The buyer can agree to a **lesser period of time** or can entirely waive the right to the federally permitted risk evaluation period. However, disclosures about the property cannot be waived by the use of an "as-is" sale provision. [40 CFR §745.110(a); See Form 313]

Pre-contract disclosure avoids cancellation

Consider a prospective buyer who indicates he wants to make an offer to buy pre-1978 residential property. The listing agent hands the prospective buyer a lead-based paint disclosure signed by the owner of the property which discloses that lead-based paint is known to exist on the property.

The prospective buyer is also handed independent reports and documents related to the existence of the lead-based paint on the property.

The prospective buyer enters into a purchase agreement offer, but does not waive the 10-day lead-based paint risk evaluation period, wishing instead to **inspect and confirm** the accuracy of the seller's disclosure since the seller's disclosure of the property condition is not a warranty guaranteeing the actual condition of the property.

After the seller's acceptance of the offer, the buyer has the property inspected. The inspector's report states lead-based paint exists as stated in the seller's disclosure documents. The buyer now seeks to cancel the purchase agreement due to the presence of lead-based paint.

Can the buyer refuse to complete the purchase of the property due to the existence of the lead-based paint as previously disclosed by the seller?

No! The buyer had full knowledge of the presence of lead-based paint and any lead-based paint hazards **prior to the seller's acceptance** of his purchase agreement offer. Thus, the buyer purchased the property **as disclosed** since the purchase agreement did not contain conditions calling for removal or abatement of the lead-based paint. The risk evaluation period only enabled the buyer to cancel had the seller not disclosed the presence of any lead-based paint or lead-based paint hazards prior to acceptance.

Thus, when the buyer entered into the purchase agreement, the buyer was **put on notice** about the presence of lead-based paint and the buyer could not later use the existence of lead-based paint as justification for cancellation.

Foreclosure sale exemption

Exempt from the Federal LBP disclosures are **foreclosure sales** of residential property. [24 CFR §35.82(a)]

Yet, a foreclosing lender still has a **common law duty to disclose known defects** at the foreclosure sale. Thus, even if the property is purportedly sold "as-is" at a foreclosure sale, a foreclosing lender is not protected from liability for intentional misrepresentation (negative fraud by omission) and deceit should the foreclosing lender have knowledge of a defect in the property and fail to disclose the defect at the time of the sale to the highest bidder. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

However, the foreclosure exemption **does not apply** to the resale of housing previously acquired by the lender at a foreclosure sale, commonly called *real estate owned* (REO) property, or to the resale by a third party bidder who acquired the property at a foreclosure sale.

Thus, if a lender or other bidder who acquired property at a foreclosure sale is reselling it, the resale must comply with the lead-based paint disclosure requirements. [61 Federal Register 9063]

Chapter 18 — Marketing condominium units

This chapter explores the listing agent's use of condominium association documents to market a unit listed for sale and to inform prospective buyers about the association and the project.

Managed housing

A buyer seeking to acquire a unit in a condominium project, or in any other residential *common interest development* (CID), is **bargaining for** living restrictions and ownership operating costs unlike those experienced in the ownership of a self-managed, single-family residence (SFR).

Ownership of a unit in a condominium project includes compulsory membership in the homeowners' association (HOA). The HOA is charged with *managing and operating* the entire project.

As a common owner of the project and a HOA member, **use and operating restrictions** are placed on most types of conduct, including:

- parking;
- pets;
- guests;
- signs;
- use of the pool, recreational and other like-type common facilities;
- patio balconies;
- care and maintenance of the unit,
- structural alterations; and
- the leasing of the premises.

The implicit bargain in becoming an owner-member is consenting to conform his conduct to meet extensive **use restrictions** in exchange for every other owner-member doing the same. The standards for the conduct consented to are found in the use restriction documents created for the project, such as association bylaws, Covenants, Conditions and Restrictions (CC&Rs) and operating rules.

The HOA has committees and a board of directors, both consisting of owner-members who are appointed to oversee the conduct of all the owner-members and their guests. On a committee's recommendation concerning a member's violation of a restriction, rule or policy of the HOA, the HOA takes steps to enforce compliance, usually by a notice of violation to the offending owner-member.

A fair comparison to the member's occupancy in a **multiple-unit housing project**, such as a condominium development, is a tenant's occupancy in an apartment complex of equal quality in construction, appearance and location. The behavior of a tenant in an apartment is also controlled by use restrictions, operating rules and policies established by a landlord.

However, a landlord is subject to market conditions when establishing guidelines for tenant conduct. Unlike a HOA, a landlord dues not rule by majority vote, committees and directors.

Yet the conduct of tenants is regulated and policed in very much the same way as the conduct of a member of a condo project is policed. In law, *security arrangements* required to be implemented and main-

tained for condo projects and apartment complexes are the same, i.e., the property is to be maintained so its use is safe and secure from dangerous defects and preventable criminal activity. Both the landlord and the board of directors of a HOA are responsible for the safety of the users of their respective multiple-housing projects. Both are managed housing.

Classification of member obligations

The bargain entered into on acquiring a unit in a CID must be understood by the prospective buyer to include a highly involved **socio-economic relationship** with all other members of the project's HOA. A commonality of interest arising out of CID ownership creates a relationship amongst the members built not only on **use restrictions** and operating rules, but also on **financial commitments** to one another.

Financially, all members collectively provide all the revenue the HOA needs to pay the expenses of present and future repairs, restorations, replacements and maintenance of all components of the structures they own in common or through the HOA.

Thus, the obligations undertaken by a prospective buyer who acquires a unit in a CID, and the HOA's documentation of those obligations, fall into two classifications:

- **use restrictions** contained in the association's articles of incorporation, by-laws, recorded CC&Rs, age restriction statements and operating rules; and
- **financial obligations** to pay assessments as documented in annual reports entitled pro forma operating budgets, a Certified Public Accountant's (CPA's) financial review, an assessment of collections and enforcement policy, an insurance policy summary, a list of construction defects, and any notice of changes made in assessments not yet due and payable.

Assessments generate revenue

Two types of assessment charges exist to fund the expenditures of HOAs:

- **regular assessments**, which fund the operating budget to pay for the cost of maintaining the common areas; and
- **special assessments**, which are levied to pay for the cost of repairs and replacements that exceed the amount anticipated and funded by the regular assessments.

Annual increases in the dollar amount levied as **regular assessments** are limited to a 20% increase in the regular assessment over the prior year. An increase in **special assessments** is limited to 5% of the prior year's budgeted expenses. [Calif. Civil Code §1366(b)]

An extraordinary expense brought about by an emergency situation lifts the limits placed on the amount of an increase in regular and special assessments. **Extraordinary expenses** include amounts necessitated:

- by a court order;
- to repair life-threatening conditions; and
- to make unforeseen repairs. [CC §1366(b)]

The schedule for payment of assessments by a member varies depending on the type of assessment. **Regular assessments** are set annually and are due and payable in monthly installments. **Special assessments** are generally due and payable in a lump sum on a date set by the HOA when making the assessment.

The buyer's expectations about assessments

To better understand the impact of assessment obligations, a prospective buyer of a unit needs to analyze the assessments based on:

- the present and future **annual operating costs** the HOA will incur; and
- the amounts which must be set aside annually as **reserves** for future restoration or replacement of major components of the improvements.

Should the association's reserves be insufficient to pay for major repairs to components of the structure which were foreseeable, a **special assessment** is used by the association to immediately call for additional funds from members to provide revenues to cover these extraordinary or inadequately reserved expenditures.

Arguably, repairs and replacements for which assessment revenues are needed to cover HOA costs are expenses any owner of a SFR would also incur. However, the difference in a CID is the individual member cannot substitute his time, effort and personal judgment for how much will be paid, when the repairs will take place, how repairs might be financed or exactly what repairs or quality of repairs are appropriate. These decisions are left to HOA committees who hopefully vote based on the same concerns and ability to pay as would the prospective buyer of a unit.

Order in the financial house

To determine if a HOA has its finances in order, a prospective buyer should look to the financial reports held by the seller or readily available from the HOA on the seller's request.

The HOA's current **pro forma operating budget** is the starting point for the prospective buyer's analysis of the financial impact the purchase of a unit in the CID will have on his income. Remember, it is the *regular assessments* which will be increased if reserves are inadequate and a *special assessment* which is levied to cover an immediate expenditure for which insufficient cash reserves exist.

The **pro forma operating budget** makes several mandatory disclosures about the state of the HOA's finances, including, but not limited to:

1. An estimate of the revenues from assessments, paid or delinquent, and the **expenses** the HOA anticipates incurring during the fiscal year covered by the budget. The revenues must exceed expenses since the HOA must set aside cash reserves for the future replacement of major components of the structure.
2. A summary of the HOA's **cash reserves** itemizing:
   - the estimated repair or replacement cost of each major component of the structure owned by the HOA;
   - the amount of cash reserves needed to pay for the repairs or replacements of these major components; and
   - the cash reserves actually on hand and available to pay for these repairs or replacements.
3. Any determination or anticipation of the HOA's board of directors as to whether **special assessments** will be required in the future for reserves, repairs, replacements or maintenance. [CC §1365(a)]

On review of the HOA's pro forma operating budget, the prospective buyer can quickly determine whether cash reserve shortages exist. If they do exist, the only way for the HOA to get the funds into reserves or immediately pay for the repairs or replacements is to increase the regular assessments (which

are paid monthly) or call for a special assessment (which will be a lump sum amount due and payable when set).

Thus, when setting the purchase price of a unit, the buyer must consider (the present value of) the amount of **deferred assessments** he will have to pay in the future, assessments which should have been levied and paid by the seller.

Some HOAs initially supply only a **summary** of the pro forma operating budget. In this case, the full budget can be requested and will be delivered without further charge.

Further, the prospective buyer needs to review additional HOA documents to fully **determine the value** (price) of the unit he is interested in purchasing and the **financial impact** assessments will have on the buyer's disposable income.

For example, another financial disclosure issued by the HOA, unless the HOA's revenues are $75,000 or less, is a **CPA's review** of the HOA's financial statement (this is not the pro forma operating budget statement). Look for comments in the CPA's review about deficiencies in reserves, delinquent assessments, or unusual accounting procedures. [CC §1365(c)]

HOA assessment enforcement policy

Also available from the HOA is a statement on the HOA's policies for enforcing collection of delinquent payments of assessments. [CC §1365(e)]

At issue for a prospective buyer of a unit is the method used by the HOA to **enforce collection** of assessments, e.g.,:

- does the HOA *record a Notice of Default* and proceed with a trustee's foreclosure on the owner's unit, a default which can be cured by the payment of delinquencies and statutorily limited foreclosure costs; or
- does the HOA *hire an attorney* and *file a lawsuit* requiring a response, a trial and results in a personal money judgment against the owner, all of which has no limit on the dollar amount of costs and attorney fees to defend or prosecute and, if not paid, becomes an abstract of judgment which is a foreclosable lien on all property owned by the owner and collectible by attaching the owner's wages or salary. [CC §§1367, 1367.1]

Also, if a "list of defects" in the structure or a disclosure of any changes already made to regular and special assessments that are not yet due and payable exists, it indicates financial inadequacies the HOA is now attempting to cure or cover. [CC §§1368(a)(6), 1368(a)(8)]

The prospective buyer of a unit in a CID needs to review all readily available HOA information with the buyer's agent **before making an offer**. With this information, the property's fundamentals become more **transparent**, allowing the buyer and his agent to better determine the price the buyer should pay for the unit and whether or not he has the ability (and desire) to carry the cost of ownership after acquisition. Even FHA insured financing requires the HOA to have maintained reserves and that delinquent assessments and investor ownership of multiple units are limited.

HOA documentation

An **association's participation** in a listing agent's efforts to induce a prospective buyer to enter into a purchase agreement and close escrow on the sale of a unit located within the project is limited to:

AUTHORIZATION TO PROVIDE CID DOCUMENTS

(California Civil Code §1368)

DATE: ____________, 20_____, at ____ California.

TO MANAGEMENT OF OWNER'S ASSOCIATION:	**FROM LISTING BROKER:**
Representative's name ______________________	Agent's name ______________________
Company name ______________________	Broker's name ______________________
Address ______________________	Address ______________________
______________________	______________________
Phone ____________ Fax ____________	Phone ____________ Fax ____________
Email ______________________	Email ______________________

1. Regarding unit number ________________________ located in the CID project which you manage known as ____ and subject to a homeowner's association (HOA) named ____.

2. You are kindly requested to provide the Listing Broker identified above within the statutory delivery period with the following checked CID and HOA documents:

a. ☐ Copies of any notice to Seller of CC&R violations, any list of construction defects, identification of any pending litigation involving the HOA and any assessment charges not yet payable.

b. ☐ Copies of HOA articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement.

c. ☐ A statement of Condition of Assessments.

3. You are authorized to supply the Listing Broker identified above the requested copies of CID and HOA documents.

5.1 Please bill me for the reasonable cost of copying and delivering these requested documents.

Owner's information:	**Signature of HOA member:**
Unit number: ______________________	
Name: ______________________	______________________
Address: ______________________	
______________________	______________________
Phone: ______________ Fax: __________	

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- **providing the listing agent**, on written request from the owner of the listed unit, with documents which include items, statements and reviews regarding the permissible use of the unit and the financial condition of the HOA [CC §1368(b); see Form 135 accompanying this chapter];
- **providing escrow**, on written request from the owner of the listed unit, with documents which include notices, statements, lists and disclosures regarding the status of the owner's membership in the HOA; and
- **changing HOA administrative records** to reflect the identification of the new owner should the prospective buyer purchase the unit.

The HOA may charge a **service fee** equal to their reasonable cost to prepare and deliver the documents requested by the owner. A charge in connection with the change of ownership is permitted, but is limited to the amount necessary to reimburse the association for its actual out-of-pocket cost incurred to change its internal records to reflect the new ownership of the unit. [CC §§1366.1, 1368(c)]

Within 10 days after the postmark on the mailing or hand delivery to the HOA of a written request from the owner itemizing the documents sought from the HOA, the **association is obligated** to provide them to the owner. A willful failure to timely deliver up the requested documents subjects the HOA to a penalty of up to $500. [CC §§1368(b), 1368(d)]

The association documents regarding use restrictions and financial data should be delivered by the owner's listing agent to a prospective buyer prior to entering into a purchase agreement. When disclosures are received before agreeing to buy, the buyer does not have a valid reason to later use this information to terminate the purchase agreement.

Status documents are also available from the HOA on request (usually by escrow) prior to closing. Using these documents, the buyer confirms the owner's representations in the purchase agreement about the status of his occupancy and the assessments imposed on the unit he is selling.

Escrow's only concern with HOA documents is the receipt of information for the purpose of prorations made necessary by prepaid or delinquent assessments.

The closing documents needed by escrow and the buyer regarding the owner's status with the HOA include:

- the CID's *statement of condition of assessments* in order for escrow to calculate **prorates and adjustments** on closing; and
- any HOA notices to the owner of CC&R violations, a list of construction defects and any assessment charges not yet due and payable in order for the buyer to **confirm the representations** made by the owner in the purchase agreement.

When a real estate broker or his agents provide a copy of the use restriction documents or the covenants, conditions and restrictions (CC&Rs) of a homeowners' association to any person must use a **cover page or stamp** on the first page of the CC&Rs. The cover page or stamp must state, in at least 14-point boldface type, the following:

> "If this document contains any restriction based on race, color, religion, sex, sexual orientation, familial status, marital status, disability, national origin, source of income as defined in subdivision (p) of Section 12955, or ancestry, that restriction violates state and federal fair housing laws and is void, and may be removed pursuant to Section 12956.2 of the Government Code. Lawful restrictions under state and federal law on the age of occupants in senior housing or housing for older persons shall not be construed as restrictions based on familial status."

However, the requirement to include this declaration does not apply to documents submitted to the county recorder for recordation.

Listing agent's role

Unless a listing agent is remiss, or simply ignorant of his duties owed to prospective buyers, he knows exactly what CID information and documents he needs to gather to properly **market and disclose** to prospective buyers the material facts about a condominium unit he has listed for sale, called *transparency*.

Accordingly, it is at the listing stage that the agent should prepare the **owner's request** to the HOA to deliver up the CID documents concerning use restrictions and HOA finances. The documents are immediately available from the association and will be delivered within 10 days of the posted or hand delivered request. [CC §§1368(a), 1368(b); see Form 135]

The owner is obligated by statute to ensure the disclosures are handed to prospective buyers as soon as practicable (ASAP). It is quite easy for the owner to request and quickly receive the documents from the association. Thus, the ready availability of the documents confirms the disclosures can, as a practical matter, be made available to a prospective buyer before the owner accepts an offer. [CC §1368(a)]

However, once the owner lists the property, it becomes the **listing agent's obligation**, acting on behalf of the owner, to diligently fulfill the owner's obligation to make the association documents available for delivery to prospective buyers, ASAP.

Chapter 19 Bonded indebtedness for offsite improvements

This chapter addresses the minimum factual disclosures a seller and listing agent must make to a prospective buyer about an assessment district lien versus the special agency duty of a buyer's agent to review the assessment lien and advise the buyer.

Costs of subdividing land

The subdivision of property carries with it the need for access roads and facilities, none of which are located on any of the parcels created for sale. The parcels created for sale as lots or condominium units are themselves either improved with structures or unimproved.

All the access roads, streets, bridges, distribution systems for water, electricity, natural gas, phones and sewers, as well as parks or other community service facilities are located on portions of the subdivided lands dedicated to the public, not on the lots and units to be sold. The improvements located on the dedicated portions of the subdivided land are called *off-site improvements* since they are not located on or within the parcels sold.

Off-site improvements are constructed solely for the benefit of the parcels offered for sale. Without right-of-way access and improvements, the parcels held out for sale would have little value. It is the availability of fully improved streets, utilities and community facilities which gives value to the parcels and ultimately sets the price a buyer is willing to pay.

Financially, someone must provide the money needed to make these **long-term capital improvements**. When the developer or subdivider of the land does not have sufficient capital or the access to conventional mortgage financing to fund the construction of the subdivision's infrastructure, the subdivider or developer can establish an assessment district encompassing his subdivided lands.

Once established, the assessment district obtains the funds the subdivider needs to pay for the cost of the infrastructure improvements by selling improvement bonds. The bonds are + on each of the individual (nonpublic) parcels in the subdivision (district) for a prorata amount of the bonded indebtedness. They are not liens on the dedicated lands which are actually improved by use of the funds.

The lien for the bonds serves the same economic function as a trust deed lien for conventional mortgage financing. It is a debt that can be enforced by a foreclosure sale of the parcel liened if not paid.

The dollar amount of the lien on each parcel represents an allocation of the value of the benefits flowing from the off-site improvements to each parcel. Thus, a lien placed on each parcel to secure the long-term semi-annual repayment of the cost of the improvements on the dedicated lands, which contribute to the parcels' market value, is purchase-assist financing by any accounting technique.

Funding off-site improvements

A subdivider's financing scheme to fund off-site improvements is called **Mello-Roos** and is deceptively entitled a *special tax*. It is **not a tax**. However, the tax collection authority for each county collects the annual installments due on the 20-year amortized payoff of the Mello-Roos bonds. The annual installment payment is called an "assessment." [Calif. Government Code §§53311 et seq.]

The debt secured by each lot to repay the bonds has a principal amount which remains due and unpaid until it is prepaid or fully amortized. The interest rate on the remaining principal due is set by the rate on the bonds. At any time, the lien for the improvement bonds can be **paid off** by the owner and the "special tax" lien **released from title** to the parcel.

These infrastructure improvement bond liens are *junior* to regular property taxes.

An improvement district bonding scheme for adding improvements to the right-of-way infrastructure of an **existing neighborhood**, or in several adjoining neighborhoods, is the *Improvement Bond Act of 1915*. Here, the lots or units do not presently enjoy all the off-site improvements or facilities needed to give the parcels their maximum market value, such as sidewalks, street lighting, sewers, parks, etc. [Calif. Streets and Highways Code §§8500 et seq.]

Thus, the 1915 Improvement Act is a financing arrangement used by parcel owners who now want to upgrade the value of their neighborhoods, and with it the value of their properties.

In a democratic fashion, the owners vote to create a 1915 improvement district. Bonds will be sold to pay for the off-site improvements. If voted in, a lien is imposed on each parcel within the improvement district in a dollar amount equal to each parcel's share of the bonded indebtedness. The bonds are payable in annual amortized installments, including interest on the remaining unpaid balance, until paid.

Of course, solvent owners with available cash can pay their prorata share of the costs (equal to the value of the benefits received by their parcel) and avoid the lien. Once a parcel is encumbered, the owner may pay off the lien at any time.

On rare occasions, a Mello-Roos **servicing district** will be established. Unlike the improvement district bonds which can be paid in full at any time, the **service assessment** is annual and forever, unless scheduled to eventually "sunset." A servicing district assessment for a subdivision is comparable to a homeowners' association (HOA) assessment.

Trust deed lenders and improvement bonds

A purchase-assist lender funding a loan to be secured by a first trust deed lien on a parcel in a Mello-Roos subdivision will be junior, not only to real estate taxes, but also to the "sandwich lien" held by the bondholders who funded the construction of off-site improvements.

Thus, the lender's trust deed lien is junior and second to the lien of the improvement bond with its 20-year amortization. Should the trust deed lender foreclose and the lender acquire title, the title will remain subject to the improvement bond lien. As the new owner, the lender must pay the installments on the bond (or pay it off so the trust deed lender is truly a first/senior lienholder, subject only to regular property taxes).

Of course, the market value of property needs to equal or exceed all debts which are liens on the property, including property taxes, bonded assessments and the lender's trust deed lien, if all monetary liens are to be satisfied by the property's value. Thus, the **value** of the trust deed lender's secured position on title is the difference between the fair market value of the parcel with its on-site improvements (usually a home) and the amounts remaining due on the bonds (and any property taxes).

Misleading disclosures and improper accounting

The "special tax assessment" misnomer used to label the semi-annual installment payments due on an improvement bond lien leads prospective buyers to believe they are dealing with an annual property tax, which they are not.

As a result, sellers and listing agents, when structuring the terms for payment of the price in a purchase agreement offer, often **ignore the principal** amount of the bonded indebtedness on the property, except to prorate the current principal and interest installment on the lien.

The extensive use by organized agents of trade union purchase agreements has memorialized the financial deception. The amount of the improvement bonds is excluded from the terms and no alternative provisions for payment of the buyer's purchase price are provided. The disclosure of the bonded indebtedness assumed by the buyer is placed within the title conditions as a tax, which it is not.

Escrows officers then perpetuate the concept that the improvement lien is not part of the price to be paid by the buyer by handling the current assessment installment as a prorated item. Accounting for the **remaining principal** amount which is due, but not yet payable, is ignored.

The accounting employed in the trade union's purchase agreement for the buyer's assumption of the bond amount can best be compared to an agreement to prorate the current installment on an assumption of a trust deed note while ignoring the elephantine principal amount remaining unpaid on the note — a monetary debenture not unlike an improvement bond. Both have principal, interest and amortized installments. Both are liens on the property.

Under this **disclosure-by-proration approach**, the buyer is given insufficient information by the seller or listing agent to make an intelligent decision about assuming the lien for the bond. Alone, the purchase agreement provision probably does not satisfy the listing agent's general duty to give the prospective buyer sufficient information to actually place the buyer on notice of the bonded indebtedness.

On the other hand, it is the **buyer's agent** who has the duty to further advise his buyer about the lack of an accounting for the bond, rather than simply "going along" with the boilerplate purchase agreement pricing and proration arrangements.

Presently, the disclosure of an improvement lien as a proration of taxes has become "standard operating procedure," but remains a contractually deceptive and unacceptable accounting standard.

As a result, the California legislature stepped in during the 1990s with legislation to ensure that prospective buyers of real estate got sufficient information to make an informed decision. Sellers (and thus, their agents) were mandated to give to buyers of Mello-Roos encumbered properties:

- a **notice** of the lien for the bonded debt and an **opportunity** to decide whether or not to assume the debt before entering into a purchase agreement; or
- the **right to renegotiate** the terms for payment of the price if they have already agreed to buy before receipt of the notice.

If fully informed, the buyer (and thus the buyer's agent) would prudently require the bond amount to be credited toward the price paid since its entire principal amount has accrued and cannot be prorated.

Statutory Notice of Assessment

The sale of property comprised of one-to-four residential units and encumbered by a Mello-Roos or 1915 Act improvement bond **requires the seller** to disclose the existence and terms of the bonded indebtedness. To comply, sellers must obtain and deliver to prospective buyers a notice prepared by the improvement district office entitled either *Notice of Assessment* or *Notice of Special Tax*. [Calif. Civil Code §1102.6b]

Anyone can request a Notice of Assessment from the office of the improvement district at any time, which of course includes both the listing agent and the buyer's agent. No particular manner of request is required, be it by phone, fax or mail, since it may be an oral or written request. The district office must deliver the notice to whomever requests it, and do so within five working days of their receipt of the oral or written request. The maximum charge for the service is $10. [Gov C §53754(b)]

The seller, since he has the **primary obligation** to request the notice and deliver it to prospective buyers, should be advised by the listing agent to request the notice when entering into the listing agreement employing the broker's office to sell the property. [See Form 137 accompanying this chapter]

If the seller refuses to assist the listing agent by complying with the seller's statutory duty for disclosure of the lien, the listing agent can and should request the Notice of Assessment himself. However requested, the agent needs to include the notice in the **listing package** prepared for disclosing to prospective buyers significant relevant information about the property. Information presented in a listing package is either **mandated**, as is the case with assessment bonds, or **known** to the seller and listing agent to exist.

Occasionally, the listing agent lacks knowledge of the lien's existence and thus lacks an opportunity to deliver information on the lien to the prospective buyer prior to submission of an offer. Alternatively, the agent may know of the lien and deliberately delay disclosure until after a purchase agreement has been entered into.

However, when the prospective buyer enters into a purchase agreement with the seller before the Notice of Assessment is delivered to the buyer, the buyer has a **statutory contingency** allowing the buyer to cancel the purchase agreement. The buyer has three calendar days after hand delivery (five days after posting by mail) of the Notice of Assessment to cancel the purchase agreement by handing a Notice of Cancellation to the seller or listing agent (not escrow or the buyer's agent). [Gov C §53754(c)]

Differing duties to give notice or advise

Whether a buyer receives a Notice of Assessment before agreeing to buy or after, the contents of the notice, without explanation or additional information, has fulfilled the seller's and his agent's *general statutory duty* owed to the buyer to disclose the existence of the assessment.

On the other hand, a buyer's agent must advise the buyer about the need for further facts regarding the assessment so an evaluation of the financial impact the assessments have on the value, price, carrying costs, etc., can be made. Worse yet, if the listing agent does not actually know if a lien exists, the buyer's broker is obligated to review the **preliminary title report** in order to catch it.

Editor's note — If the purchase agreement does not provide for the assessment lien to remain of record, and the seller and buyer enter into a binding purchase agreement, the seller has agreed to deliver title clear of lien amounts.

The Notice of Assessment (special tax) is a statutory form. However, the contents of the form do not call for the entry of enough data regarding the assessment to sufficiently inform the buyer. Without additional

REQUEST FOR NOTICE OF MELLO-ROOS ASSESSMENT

(California Civil Code §1102.6b)

TO IMPROVEMENT DISTRICT OFFICE:	**FROM BROKER:**
District Name ______________________________	Agent's Name ______________________________
Address ______________________________	Broker's Name ______________________________
______________________________	Address ______________________________
Phone ______________________________	______________________________
	Phone ______________________________

You are kindly requested to prepare and forward to Broker identified above a Notice of Assessment regarding real estate referred to as

Property address ____

____,

Owner's name ____,

containing the following information as the bonded indebtedness encumbering this property:

1. The present principal balance . . . . $______________

2. The annual rate of interest ______%,

a. ☐ fixed, or ☐ variable.

3. The interest is paid through _____________, 20______.

4. Annual payments are delinquent for the years ______________________________.

5. Total amount of delinquency to bring the Assessment current. . . . . $______________

6. The amount of each annual installment . . . . $______________

7. The year of final payment and release of lien . . . . $______________

8. The bond indebtedness ☐ is, or ☐ is not, a blanket lien on the property with other properties.

8.1 If the bond is a blanket lien, a provision for release of the property from the bonded indebtedness ☐ does, or ☐ does not, exist.

Enclosed is the statutory maximum fee of $10.00 for preparing and forwarding the Notice of Assessment.

Your response is looked forward to within the statutory five-day period after your receipt of this request.

Submitting Agent's Signature: ______________________________

data on the assessment lien, the buyer cannot make an informed decision about the bonded indebtedness. The notice **only includes**:

- the amount of each annual installment (which incidently could be a variable payment due to inflation adjusted bonds); and
- the last year in which an amortized installment will be paid (thus releasing the lien encumbering the lot as fully paid).

The Notice of Assessment does not include three additional elements about the debt which are needed to determine the **extent of the obligation**, and whether the debt is one to be assumed as a credit toward the price or to be satisfied by the seller:

- the **rate of interest** the bonds bear;

- the **current remaining principal** balance due to discharge the debt; and
- whether the bond lien is a **blanket lien** on the entire subdivision or common interest development (CID), and if so, whether a partial release of a lot is available.

Neither the interest nor the principal balance can be calculated from the information provided in the notice from the assessment district's office. Hence, the buyer's agent must step forward and request this additional information from the district, which the district must then deliver.

On receipt of the additional information, the buyer and his agent now have sufficient information to commence an analysis of the bonds and make an intelligent (informed) decision on pricing, terms of payment, assumption of the bonds, etc. In a word, the buyer's agent must provide the buyer with the **transparency** needed to make decisions in the transaction.

Accounting for assessment bonds

With the differing biases expressed by the content and format of purchase agreements from differing sources, so to are the biases for handling of the accounting for bonded assessments on the liens for subdivision improvements.

Some purchase agreements treat the unpaid principal on Mello-Roos or 1915 Act bonds as **additional consideration** paid for the property by the buyer, **over and above the price** agreed to be paid in the offer. For consistency, the current annual installment is then prorated without concern for a breakdown between the installment's principal and interest, or that the buyer assumes several thousands of dollars of principal and interest installments.

Here, the (undisclosed) remaining unpaid principal due on the bonds is not included as part of the stated purchase price the buyer is paying for the property.

Thus, these purchase agreements do not provide for a calculation of the total consideration (price plus bond balance assumed) the buyer is actually paying for the property, called *acquisition costs*. This lack of disclosure is statutorily sanctioned conduct by the seller and listing agent.

However, their duty of limited disclosure does not apply to the buyer's agent under his duty owed to the buyer.

Without advice from a buyer's agent about the true nature of the improvement assessment bonds, the buyer will not begin to understand the nature of the contents of a Notice of Assessment or the payoff aspect. However, the advice of the buyer's agent is logically limited to his actual knowledge about the bond arrangements and any information readily available from the assessment district's office.

On the other hand, other publisher's purchase agreements place the accounting for the bonded indebtedness, if it is not to be paid off by the seller, in the price to be paid for the property. Thus, the buyer assumes the debt as a lien on the property owed by the seller and part of the price paid, which it is.

The treatment of the amount of the **monetary lien** for the bonded indebtedness is fully equivalent to the assumption of a trust deed lien by a buyer. The principal balance on the improvement bond lien is credited to the price to be paid by the buyer as part of the agreed price, which typically is the property's fair market value (FMV). [See **first tuesday** Form 150 §7]

The argument surrounding the two diametrically opposed accounting and disclosure procedures revolves around a determination of the property's FMV.

Would two parcels in the same subdivision improved with identical same-type housing, both have different sales prices simply because of the financing which encumbers them? At first glance, the answer is no.

However, for the buyer to be fully advised by his agent about the consequences of both an assumption of the improvement bonds as part of the price paid for the property, or conversely, as an additional amount to be eventually paid but not accounted for as included in the price, then both of the accounting schemes are *transparent:*

- if the price offered **includes** an assumption of the bond amounts (or the seller is to clear title of the lien), the price will represent the property's FMV (which by definition is free and clear of monetary liens); or
- if the price offered **excludes** the bond amounts which are assumed, the price offered will be less than the property's FMV by the exact amount of the lien for the balance due on the bond.

Therefore, both offers would, in the final accounting, be paying the same total consideration as the **cost of the acquisition** of identical houses in the same subdivision since both houses are subject to the same amount of bonded indebtedness.

Chapter 20 — Tax aspects advice

This chapter clarifies the extent of an agent's duty to inform his client about the tax aspects of a proposed real estate transaction.

Disclosure of known consequences

Consider an owner of an income-producing parcel of improved real estate who intends to hire a brokerage office to market his property and locate a buyer. The owner interviews a few brokers and sales agents to determine who he will employ to list the property for sale.

The owner's primary concern is to hire an agent who is most likely to produce a prospective buyer who will purchase the property. Thus, the **owner's interviews** include an inquiry into:

- the **contents of the listing package** the agent will prepare to market the property;
- the **scope of the advertising** the agent will provide to locate prospective buyers; and
- the **professional relationship** the agent has with other brokers, agents and property owners.

One agent interviewed by the owner inquires about the owner's *intended use of the proceeds* from the sale. The owner indicates he would like to reinvest the funds in developable land, to hold for profit on a later resale to a subdivider or builder.

On further inquiry, the owner provides the agent with *data on the price* he paid for his property, the *debt* now encumbering the property and his depreciated *cost basis* remaining in the property. These three key pieces of data are needed for an agent to assist the owner in his **tax planning** for a sale.

The agent does some quick math (sales price minus basis equals profit) to approximate the amount of profit the owner will realize on a sale. He immediately determines the owner would pay profit taxes at *recapture* (25%) and *long-term* (15%) rates that will equal nearly one fifth of his net proceeds from a sale (plus one twelfth for state taxes). The owner is informed of the agent's initial opinion about the owner's tax liability on a sale.

The agent then informs the owner he can **avoid reporting his profit** and paying income taxes on the sale by buying the land he would like to acquire now. Thus, the sale of his income property and his purchase of land can be linked together to form a **continuing investment** in real estate.

Also, the agent informs the owner that the purchase agreements entered into for the sale of the income property and the purchase of the land should contain **contingency provisions** conditioning the closing of the sale on the owner's purchase of other property.

So as not to mislead the owner about the extent of the **agent's experience** handling §1031 reinvestment plans for clients, the agent informs the owner he has not personally handled a §1031 transaction. However, he lets the owner know he has taken courses on §1031 transactions and has discussed §1031 funding procedures with brokers and escrow officers who do have experience handling §1031 reinvestments.

The agent tells the owner he believes he can properly market the property and locate suitable land for the owner's reinvestment, as well as follow up on procedures for §1031 tax avoidance should the property be listed with his broker.

Conversely, another agent contacted by the owner is reticent about becoming involved in a review of the tax aspects of selling property.

This agent hands the owner a **written statement** attached to a proposed listing agreement advising the owner that the agent:

- has disclosed the extent of his *knowledge* of the tax consequences on the sale of real estate;
- is unable to give *further tax advice* on the rules and procedures involved in a §1031 transaction; and
- has *advised the owner* to seek the advice of his accountant or tax attorney on how to properly avoid the tax on profit from the sale and purchase of real estate.

Did both agents comply with their agency duty to make proper disclosures to the owner about their knowledge and willingness to give tax advice?

Yes! Both agents met the **agency duty** undertaken when soliciting employment since each agent:

- **determined the tax consequences** of the sale might **affect** the owner's handling of the sales transaction, called a *material fact*;
- **disclosed the extent of his knowledge** regarding the possible tax consequences of the sale; and
- **advised on the need for a professional** who would further investigate and advise on the §1031 tax aspects.

The question then remains, "Must a broker, employed by a seller of real estate, give tax advice to the seller?"

The answer lies in the **type of real estate** involved and the client's intended use of the sales proceeds.

An affirmative duty to advise

Consider a listing agent who determines that information about the tax aspects of a sale is *material* to a sales transaction entered into by his client since tax information might affect the client's handling of the transaction. Accordingly, the agent has a duty owed to his client to disclose the extent of his knowledge on the transaction's tax aspects, called an *agency duty* or *fiduciary duty*.

Further, a concerned listing agent will go beyond disclosure of mere tax information and assist his client in structuring the sales arrangement to achieve the best possible tax consequences available.

However, a **statutory exception** to the disclosure duties exists. On one-to-four unit residential dwellings, a listing agent has **no duty to disclose** his knowledge of possible tax consequences, even if the tax consequences are known by the agent to affect the client's decision on how to handle the sale of his property, unless the topic becomes the subject of the client's inquiry. [Calif. Civil Code §2079.16]

Advice and disclosure exception

Consider a seller of a one-to-four unit residential property who enters into a client-agent relationship with a broker, employing the broker (and his agents) to sell the property under a listing agreement.

The listing agreement form used by the broker contains a boilerplate clause stating a real estate licensee is a person qualified to advise on real estate, a statement that is consistent with the training and knowledge of brokers and agents. However, the clause goes on to state that if the seller desires legal or tax advice, he should consult an appropriate professional. [CC §2079.16]

The broker also hands the seller a statutorily mandated **agency law disclosure** form that states: “A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.”

Neither disclaimer requires the broker and his agents to provide tax advice or obligates the seller to employ the other professional to advise on the tax aspects of the transaction before closing escrow. [CC §2079.16]

The broker then locates a buyer who enters into a purchase agreement with the seller to buy the property. The purchase agreement also states the seller should consult his attorney or accountant for tax advice.

Prior to closing the sale of the seller’s property, the broker also negotiates the seller’s purchase of another one-to-four unit residential property, which involves the broker’s preparation of a purchase agreement.

Before the separate escrows close on the sale and purchase transactions, the seller asks the broker about the number of days he has after the sale closes to purchase the replacement property and avoid paying profit tax on the sale. The seller has never been involved in a §1031 reinvestment.

The broker informs the seller he is not sure of the number of days and orally **advises the seller to consult a tax accountant**. The seller does not do so since no contingency provision for further-approval of the tax consequences was in the purchase agreement.

Ultimately, the seller is taxed on the profit from the sale, but not because of the time constraints on his closing of escrow that he inquired about. The profit is taxed because the seller failed to avoid actual and constructive receipt of the sales proceeds. Avoidance is simple, either:

- directly transfer the sales proceeds to the purchase escrow; or
- impound the sales proceeds with a third-party facilitator until the proceeds are needed to fund the purchase escrow for the replacement property.

The seller seeks to recover his losses from the broker. He claims the broker breached the agency duty owed to the seller by failing to disclose that the structure of the seller’s transfer of net sales proceeds from the sales escrow to the purchase escrow for the replacement property might result in **adverse tax consequences** due to his actual receipt of the reinvestment funds.

The broker claims he has **no duty to advise the seller on the tax consequences** of the one-to-four unit sale since the listing agreement, the **agency law disclosure** and the purchase agreement all clearly stated:

- the broker did not advise on tax matters; and
- the seller should look to other professionals for tax advice.

Did the listing broker (or his agents) have a duty to advise the seller on the tax consequences of the sale as known to the broker (or his agents)?

No! On the sale of **one-to-four unit residential property**, sellers (and buyers) are expected, as a matter of public policy, to obtain tax advice from competent professionals other than the residential real estate brokerage office handling the transaction. [CC §2079.16]

Further, a broker has no duty to voluntarily disclose any tax aspects surrounding the sale of a one-to-four unit residential property, even if the **information is known** to the broker or the sales agent. However, the listing agreement needs to specify the broker and his agents **do not undertake the duty** to advise the seller on the tax aspects of the transactions. Further, on a **direct inquiry** from the seller (or buyer), the

agent must **respond honestly** and to the best of his knowledge. [**Carleton** v. **Tortosa** (1993) 14 CA4th 745]

The agency law disclosure addendum attached to listing agreements and purchase agreements **eliminates the duty** of a broker and his agents to disclose their knowledge about the tax aspects of a sale when a one-to-four unit residential property is involved.

The irony of mandated disclosures

The tax consequences of sales transactions involving the subsequent purchase of replacement property are as material to a seller as is the structuring of carryback financing. Carryback financing arrangements require an agent to make extensive mandated disclosures regarding documentation of the carryback and the rights of the carryback seller. However, carryback arrangements are less frequently encountered during boom times than §1031 reinvestment opportunities.

Further, the financial damage of avoidable taxes often exceeds the risk of loss on an improperly structured carryback note and trust deed transaction. Unlike the agency duty of a broker (and his agents) in §1031 transactions, the agency duty a broker (and his agents) owes to his carryback seller includes full disclosure of information necessary for the seller to make an informed decision about the **financial suitability** of a carryback sale before the seller enters into the transaction. [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860]

Avoiding misleading disclaimers

The boilerplate statement included in some listing agreements and purchase agreements used by unionized real estate brokers and their agents incorrectly implies that they are not qualified to give tax advice.

If a broker or agent is not **fully qualified** to handle the sale and purchase aspects of a §1031 transaction, he is at least aware of its beneficial tax aspects available to a seller of property.

Further, real estate brokers and their agents *with tax knowledge* are **duty-bound to advise their client** about their knowledge concerning the tax consequences of the real estate transaction their client is about to enter into — unless a one-to-four unit residential property subject to agency law disclosure statutes is involved.

However, a savvy broker or agent **capitalizes** on the tax knowledge he has spent time acquiring by advising clients on the tax results of their real estate transactions, regardless of the type of property involved. When a broker or agent uses his knowledge to **voluntarily counsel** his client on the transaction's tax consequences, the decision made by the client will be the result of more relevant information.

However, the broker or agent who advises a client on a transaction's tax consequences has a duty to not mislead the client by intentional or negligent misapplication of the tax rules. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

To **avoid misleading the client,** the broker or agent should disclose to his client:

- the full extent of his tax knowledge regarding the transaction;
- how he acquired his tax knowledge; and
- whether the broker or agent intends to further investigate the matter or whether the client should seek further advice from other professionals.

When a broker or agent does give tax advice, he should take steps to involve the **client's other advisors** in the final decision. Input from others who know the client help the broker eliminate future claims arising out of adverse tax consequences due to the **client's reliance** on the agent's (incorrect) opinion.

The most practical (and effective) method for shifting reliance to others or to the client himself when the broker gives a client his opinion on a transaction's tax consequences, is to insert a *further-approval contingency* in the purchase offer or counteroffer.

The **contingency provision** requires the client to initiate his own **investigation** by obtaining additional tax advice and further approval of the transaction's tax consequences from his attorney or accountant before allowing escrow to close.

An oral or written warning, or **general advice** to further investigate, is not sufficient. Advisory statements do not require the client to act, and worse, they do not explain why the broker or agent believes the client should act to protect himself. A further-approval contingency provision makes the advice an *opinion*, to be confirmed by the client before closing. [**Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18]

Tax advisor's further approval

In an exchange agreement (or purchase agreement), the purpose for including a further approval contingency regarding the transaction's tax consequences is to allow a client to confirm that the transaction does qualify for §1031 tax-exempt status as represented by his agent. If the tax status cannot be confirmed, the client may terminate the transaction by delivery of a notice of cancellation. [See **first tuesday** Form 171 §5.2j]

In other words, the client is **not relying** on the agent's opinion if he decides to enter into an exchange agreement with the intent to close escrow only after he has further confirmation of the tax consequences.

However, a purchase agreement or exchange agreement that contains a written contingency provision calling for a third party's approval of some aspect of the transaction, such as the transaction's qualification as an Internal Revenue Code (IRC) §1031 reinvestment plan, also contains an unwritten *implied covenant* provision. Under the implied covenant provision, before a client can cancel a transaction, he is required to "act in good faith and with fairness" in his efforts to obtain a third party's approval, such as submitting data on the transaction for confirmation from his attorney or accountant.

Thus, the **implied covenant provision** compels the client to actually submit documentation on the transaction to the third party, and to do so within the time period called for after the date of acceptance.

Here, the client's agent usually steps into the chain of events by contacting the third party and providing the paperwork sought to review the transaction for its §1031 tax-exempt status. On review, procedural changes may need to be made to meet the client's objectives and satisfy the objections of the third party. In response, the agent sees to it the changes are made, unless the changes would be inconsistent with the intent of his client regarding his acceptance of the replacement property.

Since fair dealing and reason are implied in every agreement and applied to the conduct of all parties, a termination of the exchange agreement due to the disapproval of an activity or occurrence subject to a contingency provision must be based on a **justifiable reason**.

On a potential disapproval and possible termination due to reasons expressed by the client or his advisor, the agent may well be able to cure the defect that gave rise to the reason for disapproval or to demonstrate

that the third party's concern is unfounded, i.e., if it is, in fact or in law, an erroneous conclusion. [**Brown** v. **Critchfield** (1980) 100 CA3d 858]

Tax aspects: a material fact

All real estate in the hands of a seller is classified as either his principal residence, like-kind (§1031) property or dealer property.

An inquiry as to what the seller of property other than a personal residence or dealer property intends to do with the sales proceeds often opens a *window of opportunity*, allowing the agent to review his **tax knowledge** with the seller.

When representing sellers of real estate that, on a sale, would qualify for the §1031 profit reporting exemption, an agent should use a purchase agreement containing a §1031 cooperation provision. [See Form 159 §10.6 accompanying Chapter 35]

A **§1031 cooperation provision** is not an advisory disclaimer by which a broker or agent attempts to relieve himself of his responsibility to give tax advice. Instead, the provision *puts the seller on notice* he is able to avoid profit reporting on the sale and has bargained for the buyer's cooperation should the seller decide to act to qualify his profit for a §1031 exemption.

Again, an agent who is not knowledgeable about the handling required for a §1031 reinvestment can initially avoid a discussion of tax aspects by including the §1031 cooperation provision in the purchase agreement. The §1031 cooperation provision conveys to the seller the seller's need to consider, plan for and inquire about the tax consequences of the sale.

Knowledge of basic tax aspects

Technical questions posed by a seller that go beyond a listing agent's knowledge or expertise requires a truthful response from the agent. In response, the **listing agent** has several ways he can respond, including:

- *disclosing* the extent of **his knowledge** to the seller and *advising* the seller to seek any further advice they may want from another source;
- *associating* with a more knowledgeable broker, a tax attorney or accountant who provides the seller with the advice; or
- *learning* how to handle §1031 reinvestments and giving the advice himself.

Escrow officers are of great assistance to an agent who is aware he has a potential §1031 transaction. Some escrow officers and agents advertise their expertise in handling §1031 tax- deferred reinvestments to broadcast their competitive advantage over other escrow officers and agents.

Ideally, every broker and agent handling the sale of real estate used in the seller's business or held for investment (like-kind property) should, as a **matter of basic competency**, possess an understanding of several fundamental tax concepts, such as:

- the principal residence owner-occupant's $250,000 profit exclusion;
- the separate income and profit categories for each type of real estate;
- the §1031 profit reporting exemption;
- interest deductions on real estate loans;
- depreciation schedules and deductions;
- the $25,000 deduction and real-estate-related business adjustments for rental property losses;

- the tracking of rental income/losses separately for each property;
- profit and loss spillover on the sale of a rental property;
- standard and alternative reporting and tax bracket rates; and
- installment sales, deferred profit reporting.

All of these tax aspects are basic to the sale or ownership of real estate commonly listed and sold by agents. When applicable, they have significant financial impact on sellers and buyers of real estate. Any agent with a working knowledge of the tax aspects of real estate can and should consider offering a wider range of services, including tax advice, when competing to represent buyers and sellers.

Also, giving a seller tax advice concerning a §1031 reinvestment plan when the seller follows the advice always leads to a second fee for negotiating the purchase of the replacement property and coordinating the transfer of funds.

Chapter 21 Prior occupant's use, affliction, and death

This chapter discusses the disclosure of a prior occupant's death or affliction with AIDS.

When and when not to disclose

A real estate broker and his listing agent are employed by a seller to locate a buyer for his real estate. The listing agent soon locates a buyer who wants to purchase the property.

Prior to making an offer, the listing agent hands the buyer the seller's Transfer Disclosure Statement (TDS) disclosing the seller's and agent's knowledge about the present **physical condition** of the property. All other mandatory disclosures are made.

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, the buyer is informed a prior occupant died on the property from AIDS or HIV. This death occurred **more than three years** before the buyer submitted the offer to purchase the property.

The buyer discovers the listing agent knew of the prior occupant's AIDS affliction and death on the property. The buyer claims the listing agent breached his agency duties by failing to voluntarily disclose this information to the buyer.

Here, a real estate agent has no *affirmative duty* to **voluntarily disclose** information to a potential buyer regarding a prior occupant:

- whose *death*, from any cause, occurred on the real estate **more than three years prior** to the purchase offer; or
- who was *afflicted* with the HIV virus or afflicted with **AIDS**. [Calif. Civil Code §1710.2(a)]

*Editor's note — Deaths on the property which occurred **within three years** of the offer are treated differently.*

Disclosure on inquiry

Consider a buyer who asks the listing agent if any deaths have ever occurred on the property.

On direct inquiry by the buyer or his agent, the listing agent must **disclose his knowledge** of any deaths on the real estate, no matter when they occurred. [CC §1710.2(d)]

An intentional misrepresentation or concealment by any agent in the real estate transaction after a buyer makes a **direct inquiry** is:

- a breach of the listing agent's *general duty* owed to the buyer to truthfully respond when the listing agent represents the seller exclusively; or
- a breach of the buyer's agent's *agency duty* owed the buyer since the agent is the buyer's representative in the transaction. [CC §1710.2(d)]

Further, an **inquiry** by the buyer into deaths indicates that a death on the premises is a fact which might affect the buyer's use and enjoyment of the property, a *material fact*. Thus, an affirmative duty is im-

posed on the **buyer's agent** to either investigate or recommend an investigation by the buyer before an offer is made, unless the offer includes a contingency on the subject of death.

An agent who discloses, on inquiry, that he does not know if a death occurred on the real estate, or has limited information which he does disclose, should hand the buyer a memorandum stating:

- the buyer has made an inquiry about deaths on the property;
- the agent has disclosed all his knowledge concerning the inquiry; and
- whether the agent will further investigate any deaths on the property.

Deaths affecting market value

An agent's duty to disclose facts known to them which may adversely affect the property's value, called *material facts*, is not limited to disclosures of the property's physical condition.

Consider a buyer who enters into a purchase agreement negotiated by an agent, acting either as the buyer's agent or the listing agent. The offer includes the seller's TDS disclosures about the condition of the property as an attachment. However, the buyer is unaware multiple murders occurred on the property more than three years before the buyer's purchase offer.

The agent **conceals his knowledge** of the murders from the buyer. The agent is aware that the notoriety of the murders *adversely affects* the market value of the property, placing its value below the price the buyer is agreeing to pay.

The transaction closes and the buyer occupies the property. The buyer learns of the murders and sues the agent to collect his price-to-value money losses. He claims the agent had a duty to disclose the deaths since the agent knew the property's market value, due to the stigma of the deaths, was **measurably lower** than the purchase price paid.

The agent claims he does not have a duty to disclose the deaths since they occurred over three years ago and were not required to be disclosed on the TDS.

Did the agent have an affirmative duty to disclose the deaths?

Yes! The deaths had an **adverse affect** on the property's market value and were **material facts** intentionally concealed from the buyer.

Thus, every agent has an affirmative duty to disclose prior deaths when the death **might affect the buyer's valuation** or desire to own the property. [**Reed** v. **King** (1983) 145 CA3d 261]

Desirability based on prior events

Consider a buyer's agent who is aware a death occurred on the real estate **within three years** of a buyer's purchase offer. The value of the property is **not adversely affected** by the death. Thus, the knowledge is not a material fact about the property which needs to be disclosed.

The buyer does not ask his agent if any deaths have occurred on the property.

After closing, the buyer learns of the death and is deprived of the pleasurable use and enjoyment of the property — an **idiosyncracy** of the buyer about death which was unknown to his agent.

The buyer claims his agent breached his special agency duty by failing to disclose the death since it inflicted an intangible harm on the buyer, preventing him from occupying the real estate.

Here, the buyer's agent probably should have inquired of the buyer to determine if a known death might affect the buyer's decision to purchase the property. The buyer's agent does have a greater agency duty to care for and protect the buyer than does a listing agent. Thus, a buyer's agent should disclose any death occurring on the property within three years, especially if he believes the death might affect the buyer's decision to make a purchase agreement offer.

It is the buyer's agent's duty to **investigate and disclose** material facts about the property and the transaction, placing a greater burden on the buyer's agent to know and understand his client, a sort of **know-your-client rule**.

Conversely, the **buyer has a duty** of care, owed to himself, to *inquire and discover* facts to protect his personal interests.

However, whether or not a buyer's agent will be subject to any liability or penalties for not disclosing a death which occurred on the property within three years of the buyer's purchase offer, when the agent was **unaware of the buyer's idiosyncracy** and the death was not a material fact affecting the value of the property, has yet to be reported.

Chapter 22 Income property operating data

This chapter focuses on the data a listing agent needs from a seller on any type of income producing property before the listing agent is able to diligently market the property to prospective buyers.

Fundamentals induce offers

It is said about an income property's operating data that it is both the commencement and conclusion of a transaction.

An income producing property's operating data is gathered and entered on an Annual Property Operating Data (APOD) sheet by the seller or listing agent. The purpose of preparing an APOD is to provide information about the property to prospective buyers or their agents.

By design, the APOD is **intended to induce** prospective buyers to rely on its content to buy the property. Thus, with the presentation of an APOD to a prospective buyer, negotiations have begun.

If negotiations are successful, a prospective buyer enters into a purchase agreement with the seller. The conclusionary act by the buyer and the buyer's agent is the completion of their due diligence investigation into the accuracy of the income data contained in the APOD.

To do so, the buyer's agent reviews the operating expenses, rent rolls, leases and tenant estoppel certificates. If the certificates are substantially the same as the data contained in the APOD and the leases, and the expenses are verified, the transaction closes.

Thus, on close of the transaction, the income and expenses experienced by the property and presented on an APOD by the listing agent have come full circle. The buyer's receipt of the APOD on **introduction** to the property has been tied to the **confirmation** of the APOD figures and the transaction has closed.

Honest start equals strong finish

The price an investor will pay for income producing real estate is set by a property evaluation analysis of data based on different appraisal techniques, one of which is the *income approach*. When another evaluation approach sets a value different than set by the income approach, the lesser of the values should greatly influence the investor's decision on pricing.

This chapter is concerned primarily with the **income approach to valuation** since income is initially used by investors to determine a property's fair market value (FMV) and the ability of the rents to service debt. Here, comparable sales or depreciated replacement cost approaches are of secondary concern.

Rental income and operating expenses produce a property's *net operating income* (NOI). In turn, the property's NOI represents the annual return the property delivers to the owner, which is accounted for as:

- a **return of** the owner's original capital investment, called *depreciation*, (evidenced in part by the principal reduction on purchase-assist loans); and

- a **return on** the owner's capital investment, called a *yield*, (including NOI used to service interest payments on the purchase-assist loans).

Since the NOI represents the investor's annual returns, the information and data entered in an APOD are the **fundamentals** upon which an income property investment is initially judged for setting its market value. Thus, the APOD prepared by the listing agent must contain accurate representations of either:

- **current operations**, as experienced by the seller; or
- an **opinion honestly held** by the agent about future income and expenses which an investor will likely experience as owner of the property.

Thus, a prospective buyer of income property is buying a **future flow** of income (NOI) for which he is willing to pay a price today. This price is the **discounted, present worth** of the property's NOI over the coming years. Further, this is the maximum price the prospective buyer would agree to pay for the property.

By the listing agent's use of an APOD, the prospective buyer is *induced to rely* on the APOD figures to evaluate the property, enter into negotiations, and sign a purchase offer. If the figures hold up under an investigation, the buyer will acquire ownership of the property.

For the listing agent to avoid deceitful and dishonest activities in the inducement, the figures entered in an APOD must have some close relationship to the income and expenses the property actually does or will likely produce. The only known **sources of data** for the APOD figures which the listing agent can draw on are the owner's actual operating records of the property and the operations of comparable properties. Both are readily available to agents on inquiry.

The need for forecasts

Data from comparable properties might demonstrate that the listed property's current operations are producing less rental income and greater expenses than experienced by owners of other properties.

The comparison may justify the preparation of an APOD using figures which are decidedly not reflective of the property's current operating income and expenses. Instead, the APOD figures represent the listing agent's opinion about the property's probable future operations based on the income and expenses experienced by both the listed property and comparable properties.

Here, the listing agent must have a reasonable basis for developing a **rational opinion** about the property's future potential by estimating the anticipated income and expenses. The estimate is the listing agent's *forecast* of income and expenses which the listing agent **honestly believes** has a reasonable likelihood of actually occurring under new ownership.

Thus, two entirely different NOI estimates could logically be presented to a prospective buyer regarding the listed property:

- one based on **current operations** as continuing without a significant change in anticipated income and expenses, properly called a *projection*; and
- the other being an **opinion** of potential income and expenses likely to be experienced in the future, properly called a *forecast*.

The difference in the NOI produced by these two estimates of the property's future annual operations has a profound **financial impact** for the property's value. A $10,000 potential increase in annual NOI over the current NOI experienced by the seller converts, by the financial process of *capitalization of income*, into an increase in value ranging from $80,000 to $120,000. The range depends on the rate of return ex-

pected in the marketplace at the time of sale. It is in the best interest of the seller for the listing agent to put forward on an APOD the best set of figures which the listing agent honestly believes an owner could actually achieve.

However, the listing agent must be certain the buyer does not rely on the APOD figures as a *warranty* or anything more than the listing agent's **honestly held belief** that the NOI estimated has a reasonable likelihood of occurring. Listing agents must accompany their optimistic forecasts on APODs with a statement indicating the figures are *opinions* and nothing more.

If the buyer receives positive assurances from the listing agent that the APOD figures are **attainable**, the buyer can rely on the APOD as a *guarantee* of what will occur. Then, the buyer may rely on the data unconditionally presented by the listing agent without further investigation to confirm whether or not the assurances will occur. [**In re Jogert, Inc.** (9th Cir. 1991) 950 F2d 1498]

A contingency provision in the purchase agreement calling for the buyer's further approval of the income and expenses would be prudent to demonstrate that the buyer is not relying on the agent's APOD estimates as a guarantee.

Seller's good-faith assistance

To assist a listing agent to marshall information about a property's operations and prepare an APOD to determine the property's current NOI, the seller must, *in good faith*, provide the listing agent with printouts of his monthly, year-to-date and past 12 months income and expense statements. Either the seller, the property manager or resident manager have or can generate this operating information for the listing agent.

An owner, having employed a listing agent to market his income property and locate a buyer willing to pay the listed price, owes a duty to the listing agent to make a good-faith effort to cooperate and assist the agent to meet the objectives of the employment. Otherwise, the seller *wrongfully interferes* with the agent's ability to successfully market the property (and earn a fee). Without accurate operating data, income property cannot be honestly marketed to prospective buyers.

In turn, the listing agent's duty as the seller's agent is to deliver to his seller the best business advantage **legally achievable**. This duty is tempered by the listing agent's *general duty* owed to prospective buyers to provide them with accurate factual information about the integrity of the property which may adversely affect the value of the property, and to do so before the buyer enters into a purchase agreement.

To meet this affirmative disclosure duty owed to prospective buyers, the listing agent must provide prospective buyers or their agents with information **known or readily available** to the seller or listing agent. These disclosures include information about the operations of the property which **might affect** the decisions of a reasonably prudent buyer regarding acquisition of the property. As a result, the listing agent must present known facts to a prospective buyer in a manner which will not mislead or deceive the buyer by omitting factors adversely affecting the property's value.

If the seller or his property manager are the source of the information on the property's operations, and the listing agent has no reason to believe the data is false, the listing agent has no duty to prospective buyers to investigate the truthfulness (accuracy) of the information. However, the **source of the data** must be disclosed.

The APOD

An APOD, prepared by a listing agent and handed to a prospective buyer, provides operating information on the property, including:

- the **estimated NOI**, for setting the price to be paid and the loan amounts which can be serviced by the income generated by the property;
- the **spendable income**, for providing a cash-flow cushion reflected by the amount of the NOI remaining after servicing the mortgage financing (including information on trust deed balances, monthly payments, interest rates and any due dates); and
- the **income tax consequences** the prospective buyer will likely experience during the first year of ownership due to allowable deductions of interest on trust deed loans and standard depreciation schedules.

In the comment's section of the APOD form, the listing agent enters local trends and factors **known to the listing agent** which may not be observable by a prospective buyer or the buyer's agent when viewing the property, or discoverable by them when reviewing the marketing package. Local trends and factors include currently evolving economic or regulatory conditions which might affect the property's future income or expenses, and thus, impact the prospective buyer's decision to buy or use the property.

Economic impacts include:

- population demographics in the location of the property as decreasing, static or increasing in density;
- the local population's future effect on the appreciation or depreciation of the property's value;
- whether the quality and location of the property will, in the future, support the APOD's income and expense analysis; and
- the rents and expenses experienced by comparable property in the area.

Income property expense ratios

Expenses, as a percentage of scheduled income, are calculated on the APOD in the center column. Percentages are obtained by dividing each expense item by the (100%) scheduled income. [See Form 352 accompanying this chapter]

The percentage calculated for each operating expense alerts the prospective buyer and his agent to data which varies from a range typically experienced by the type of income property involved.

For example, if the percentage allocated to utility expenses is abnormally high compared to other properties, this cost should be evaluated to determine:

- what can be done to bring the utility expenses within the normal percentage range; and
- what effect the expense has on the value of the property, other than reducing the NOI.

Information which needs to be separately disclosed to a prospective buyer so he can determine the property's worth includes recent "spikes" in expense items, such as:

- utilities;
- evictions necessitated by delinquencies;
- security re-evaluations needed due to incidents of crime on the premises;
- loss of a local industry which employs a significant percentage of area tenants;
- assumable or locked-in financing;

- rent control adjustments; and
- loan commitments.

Loan payments

Loan payments entered on the APOD should reflect only the principal and interest payment, separate from any impounded (escrowed) funds deposited with the lender as part of the monthly payment. Impounds, however, should be disclosed elsewhere in the APOD.

Impounds are merely a **reserve** for some of the owner's fixed operating expenses (already figured into the NOI), such as property taxes, improvement district assessments, and the hazard insurance premium. The lender will pay these expenses on behalf of the owner using the impounded funds.

Deposits into an impound account are not a loan charge or an operating expense. However, the lender's later disbursements from the impound account represents payment of the owner's operating expenses.

The amount of any monthly impound deposit will change on transfer of the property's ownership, typically due to an increase in property taxes triggered by reassessment due to the change of ownership. The buyer's agent calculates the increase in the impounds and enters the estimated future impound payment on the APOD, not the seller's present impound payment.

Data approved for release

As a service to his seller, a listing agent can prepare the APOD if all the verifiable rents and expenses are made known to the agent by the seller. Unless a seller is willing to "lay open" the books on the property to the listing agent so its operations are sufficiently transparent to **provide verifiable data** for a prospective buyer, this listing goes nowhere.

Before the listing agent can effectively market the property, the APOD has to be prepared for delivery to prospective buyers. Again, the APOD can be prepared to reflect either:

- the property's **current operations**, which implicitly infers that the figures given will more than likely occur during the following year; or
- the property's **potential future operations**, influenced by income and expenses now experienced by comparable properties and trends in rents and operating expenses in the surrounding area.

When the APOD is completed to the satisfaction of the listing agent and the seller, the seller should **sign a copy** for the listing agent's file. Thus, the seller acknowledges his approval of the contents of the APOD and consents to the release of the figures.

With a seller-approved APOD in the listing file, the APOD becomes the centerpiece of the listing agent's marketing (listing) package to be presented to prospective buyers or buyer's agents.

Duties owed the buyer

A listing agent owes a **general duty** to a prospective buyer and buyer's agent to gather together readily available information on the property and make it available to them without investigation into its accuracy, called **putting the buyer on notice**.

In turn, the **special agency duty** owed the buyer by a buyer's agent is to review the skeletal property information received from the seller and listing agent and advise the buyer as to the inquiry or investigation needed to understand and appreciate the ramifications of the disclosures.

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

DATE: ______________, 20______, at ____, California.

1. **PROPERTY TYPE:** ____

   1.1 Location ____

   1.2 APOD figures are estimates reflecting:

   a. ☐ Current operating conditions.

   b. ☐ Forecast of anticipated operations.

   c. Prepared by ____

2. **INCOME:**

			%
2.1 **Scheduled Rental Income**		$______________	100 %
a. Less: Vacancies, discounts and uncollectibles. .	– $______________		______%
b. Less: Credit card charges	– $______________		______%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]		$______________	______%
a. Other income		+ $______________	______%
2.3 **Gross Operating Income**		$______________	______%
3. **EXPENSES:**			
3.1 Electricity	$______________		______%
3.2 Gas	$______________		______%
3.3 Water	$______________		______%
3.4 Rubbish	$______________		______%
3.5 Insurance	$______________		______%
3.6 Taxes	$______________		______%
3.7 Management Fee	$______________		______%
3.8 Resident Manager	$______________		______%
3.9 Office Expenses/Supplies	$______________		______%
3.10 Advertising	$______________		______%
3.11 Lawn/Gardening	$______________		______%
3.12 Pool/Spa	$______________		______%
3.13 Janitorial	$______________		______%
3.14 Maintenance	$______________		______%
3.15 Repairs and Replacements	$______________		______%
3.16 CATV/Phone	$______________		______%
3.17 Accounting/Legal Fees	$______________		______%
3.18 ________________________________	$______________		______%
3.19 ________________________________	$______________		______%
3.20 **Total Operating Expense** [Lines 3.1 to 3.19]		– $______________	______%
4. **NET OPERATING INCOME:** [Line 2.3 less 3.19].		$______________	**______%**

5. SPENDABLE INCOME (annual projection):

5.1 **Net Operating Income** (enter from section 4). . . . . $______________ ______%

5.2

Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a. 1st	$______________	$______________	______%	__________
b. 2nd	$______________	$______________	______%	__________
c. 3rd	$______________	$______________	______%	__________

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] . . . . – $______________ ______%

5.4 **Spendable Income** [Lines 5.1 less 5.3] . . . . $______________ ______%

6. PROPERTY INFORMATION:

6.1 Price $______________; Loan amounts $______________; Owner's equity $______________.

6.2 Current vacancy rate or vacant space ______%.

6.3 Assessor's allocations for depreciation schedule:
Improvements ______%; Land ______%; Personal property ______%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available; [See **ft** Form 380] ☐ need confidentiality agreement.

b. ☐ Rent control restrictions.

c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.

d. ☐ Environmental report available.

e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]

f. ☐ Soil report available.

g. ☐ Termite report available.

h. ☐ Building specification available.

i. ☐ ____

j. ☐ ____

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) . . . . $______________

7.2 Deductions from NOI

a. Annual interest expense . . . . $______________

b. Annual depreciation deduction . . . . $______________

c. Total deductions from NOI . . . . – $______________

7.3 **Reportable Income/Loss** (annual projection) . . . . $______________

Broker: ______________________________

Address: ______________________________

____

Phone: ______________ Cell: ______________

Fax: ______________________________

Email: ______________________________

I have reviewed and approve this information.

Date: ______________, 20______

Owner's name: ______________________________

Signature: ______________________________

Signature: ______________________________

In essence, the seller's listing agent literally hands off to the buyer's agent the decision as to which points raised by the APOD figures need to be checked out to get the remainder of the story and an accurate picture of the property's earning power.

For example, the APOD and rent roll sheets may not give **critical details** about leases, such as whether or not any leases might include;

- *free-rent incentives* for a period of time preceding the commencement period stated in the written lease;
- a *downward gradation* in the amount of rent after a six or eight month occupancy on month-to-month tenancies as an incentive for a tenant to remain in possession; or
- an *option to extend* the lease at a fixed rate which might be inconsistent with the prospective buyer's expectations of rental income.

Thus, the terms of occupancy, provisions in the leases, discounts, incentives, options or first-refusal rights to additional space, etc., must be part of the buyer's inquiry, triggered by the disclosure of the fact tenants hold leases and rental agreements.

Quite possibly, the buyer's agent, on completion of the inquiry into the facts behind the numbers on the listing agent's APOD, will himself fill out an APOD form to reflect his own belief about the future operating potential of the property. For the buyer's agent, the APOD prepared as his forecast must be presented as his opinion of what likely will be the performance of the property in the hands of the prospective buyer.

No assurances by the agent equals no guarantees. However, the APOD figures given as an opinion must represent a belief, **honestly held** by the buyer's agent, that the figures have a fair chance of actually occurring in the future.

Due diligence by the buyer's agent

Once the listing agent informs the prospective buyer and the buyer's agent about the property's operating facts by delivery of an APOD, issues concerning the rent and expenses need to be investigated and analyzed by the buyer's agent. Thus, the buyer is assisted in a determination of the probability that the APOD figures will actually be experienced in the future. This **investigation or recommendation** for further inquiry includes:

- a review of any *tenant files*, including lease or rental agreements, application for rent, deposits received, credit report printouts, criminal or other background checks, photocopies of driver's licenses, credit card information for payment of monthly rent and payment history [See **first tuesday** Form 352-1];
- discovering if any units or spaces in the project have a *chronic vacancy* or turnover history requiring a downward adjustment in the price paid for the property;
- a *confirmation of expenses*, by getting quotes if necessary, on what amounts the buyer will be charged, not what the seller has been able to arrange and be charged, for hazard insurance premiums, taxes based on the price to be paid, improvement district assessments, professional management fees, and the management's opinion of APOD projections;
- determining the date of the *last rental increase*, the amount of the increase and the seller's rent increase policy employed during the past few years;
- establishing who has been providing *maintenance*, and what charges can the new owner anticipate (as well as questions on intentionally deferred maintenance);
- a confirmation of the *utilities paid* by the owner and any price fluctuations, past or anticipated;

- a review of any *criminal activity* on the premises as confirmed by the local police department and by inquiry of a few tenants;
- ascertaining the number of *unlawful detainers* (UDs) filed during the past 12 months and why those tenants had to be evicted;
- a review of any *rent control activity*, if the units are locally controlled, and a check with the local agency to determine the property's compliance and the buyer's ability to maintain or attain market rates; and
- a confirmation of any *miscellaneous income* to be received from on-site vending machines, such as laundry room equipment and supplies, food and beverage dispensers and furnishings rented to occupants.

When the buyer's agent is not willing to conduct this due diligence investigation, the agent needs to inform the buyer about the agent's knowledge concerning the data. Further, the buyer's agent needs to advise the buyer on the investigations the agent believes should be undertaken for the buyer to protect the buyer's interest.

Buyer's homeownership expenses

Consider a prospective buyer of a single-family residence (SFR) who intends to occupy the property as his principal residence. The buyer is not concerned about the rent the property will command in the rental market.

However, the buyer is interested in getting information from the seller about the **cost of owning** and operating the SFR he will occupy.

The best way for the buyer to get this data is for the buyer's agent to include a provision in the buyer's purchase agreement calling for the seller to prepare and hand the buyer an occupant's property operating cost sheet. Thus, the seller **discloses the monthly expenses** which have been incurred by the seller as the owner of the property. [See **first tuesday** Forms 306 and 150 §11.8]

Chapter 23 Seller's net sales proceeds estimate

This chapter instructs on the listing agent's use of a checklist to prepare an estimate and disclose the expenses a seller will likely incur to fix up the property for marketing, provide reports to prospective buyers, and close a sale.

Financial consequences of a sale

Probably the most pressing concern sellers of real estate have about selling is the amount of money they will receive for their property on a sale. Seller's know the net amount they receive on closing is **not the full amount** of the purchase price. However, the amount they will receive is a **calculable part** of the price.

A seller may not straight out ask the listing agent what amount escrow will hand him in exchange for conveying his property to a buyer. However, the serious nature of the unspoken concern the seller has about the amount of money he will carry away from the closing is implicit. Sellers always want to know the amount of money they will **actually receive** as *net sales proceeds* for transferring ownership.

The sole reason for employing an agent is to convert the **seller's equity** into cash by selling the property at the highest possible price.

Significantly, a seller on listing his property for sale has a **motive** which drives his decision to acquire cash, if only for the opportunities cash makes available to him. The motives range from the disposal of real estate no longer of use or in foreclosure, to the need for cash to accomplish a personal, business or investment objective. The seller may want to acquire a replacement home or a premises for his trade or business, invest in equities, bonds, or commodities markets, or simply put the cash into savings.

However, the ordinary seller has little idea how to figure the dollar amount of net proceeds a sale of his property will bring. A seller's initial belief is that the net sales proceeds will be roughly equal to his equity in the property, less a brokerage fee. The notion of retrofitting property and complying with governmental safety regulations, as well as lender payoff penalties or buyer's demands for repairs, is not known to most sellers — until disclosed.

Further, the asking price is unadjusted for the need to fix up the property and to clear the property of structural pests and accumulated defects so the property can be properly marketed.

On the other hand, agents have a working understanding of all the expenses a seller is most likely to be confronted with to market, sell and close escrow on a property.

A reasonable estimate of the likely net sales proceeds on any sale should be first prepared on a **seller's net sheet** at the listing stage and again when reviewing offers or updating the net sheet figures when changes become known. [See Form 310 accompanying this chapter]

For a listing agent, a down side always exists when making disclosures regarding net sales figures. The information might cause a prospective client to decide not to sell, or cause a seller of listed property to reject an offer and counter at a price needed by the seller but unacceptable to a buyer. It is for these pricing decisions that the net sheet information is a **material fact** requiring an *affirmative disclosure* by the listing agent of the figures which comprise the seller's net sheet and the seller's bottom line.

GOOD FAITH ESTIMATE OF SELLER'S NET SHEET PROCEEDS

On Sale of Property

NOTE: This net sheet is prepared to assist the Seller by providing an estimate of the amount of net sales proceeds the Seller is likely to receive on closing, based on the price set in the agreement, the estimated amount for expenses likely to be incurred to market the property and close a sale, and any adjustments and pro rates necessitated by the sale.

The figures estimated in the net sheet may vary at the time each is incurred due to periodic changes in charges for professional services, administration fees and work enforcement made necessary by later inspections, and thus constitute an opinion, not a guarantee by the preparer.

If the property disposed of is IRC §1031 property and the seller plans to acquire replacement property, use a §1031 Profit and Basis Recap Sheet to compute the tax consequences of the Seller's §1031 Reinvestment Plan. [See **ft** Form 354]

DATE: _____________, 20______, at ____, California.

1. This is an estimate of the fix-up, marketing and transaction expenses Seller is likely to incur on a sale, and the likely amount of net sales proceeds Seller may anticipate receiving on the close of a sale under the following agreement:

☐ Seller's listing agreement ☐ Purchase agreement ☐ Counteroffer

☐ Escrow instructions ☐ Exchange agreement ☐ Option to buy

1.1 dated _____________, 20______, at ____, California,

1.2 entered into by ____, as the Seller, and

1.3 ____, as the Buyer,

1.4 regarding real estate referred to as ____.

1.5 The day of the month anticipated for closing is _______________.

2. SALES PRICE:

2.1 Price Received. . . . . (+)$_______________

3. ENCUMBRANCES:

3.1 First Trust Deed Note . . . . $_______________

3.2 Second Trust Deed Note . . . . $_______________

3.3 Other Liens/Bonds/UCC-1 . . . . $_______________

3.4 TOTAL ENCUMBRANCES: [Lines 3.1 to 3.3] . . . . (–)$_______________

4. SALES EXPENSES AND CHARGES:

4.1 Fix-up Cost . . . . $_______________

4.2 Structural Pest Control Report . . . . $_______________

4.3 Structural Pest Control Clearance . . . . $_______________

4.4 Property/Home Inspection Report. . . . . $_______________

4.5 Elimination of Property Defects . . . . $_______________

4.6 Local Ordinance Compliance Report . . . . $_______________

4.7 Compliance with Local Ordinances. . . . . $_______________

4.8 Natural Hazard Disclosure Report . . . . $_______________

4.9 Smoke Detector/Water Heater Safety Compliance . . . . $_______________

4.10 Homeowners' (HOA) Association Document Charge . . . . . . $_______________

4.11 Mello-Roos Assessment Statement Charge . . . . $_______________

4.12 Well Water Reports . . . . $_______________

4.13 Septic/Sewer Reports . . . . $_______________

4.14 Lead-Based Paint Report . . . . $_______________

4.15 Marketing Budget. . . . . $_______________

4.16 Home Warranty Insurance. $_______________

4.17 Buyer's Escrow Closing Costs . . . . $_______________

4.18 Loan Appraisal Fee . . . . $_______________

4.19 Buyer's Loan Charges. . . . . $_______________

4.20 Escrow Fee. . . . . $_______________

4.21 Document Preparation Fee . . . . $_______________
4.22 Notary Fees . . . . $_______________
4.23 Recording Fees/Documentary Transfer Tax . . . . $_______________
4.24 Title Insurance Premium. . . . . $_______________
4.25 Beneficiary Statement/Demand . . . . $_______________
4.26 Prepayment Penalty (first) . . . . $_______________
4.27 Prepayment Penalty (second) . . . . $_______________
4.28 Reconveyance Fees . . . . $_______________
4.29 Brokerage Fees . . . . $_______________
4.30 Transaction Coordinator Fee . . . . $_______________
4.31 Attorney/Accountant Fees . . . . $_______________
4.32 Other ___________________________________ . . . . $_______________
4.33 Other ___________________________________ . . . . $_______________
4.34 TOTAL EXPENSES AND CHARGES [Lines 4.1 to 4.33] . . . . (–)$_______________

5. ESTIMATED NET EQUITY: . . . . (=)$_______________

6. PRO RATES DUE BUYER:

6.1 Unpaid Taxes/Assessments . . . . $_______________
6.2 Interest Accrued and Unpaid . . . . $_______________
6.3 Unearned Rental Income . . . . $_______________
6.4 Tenant Security Deposits . . . . $_______________
6.5 TOTAL PRO RATES DUE BUYER [Lines 6.1 to 6.4] . . . . (–)$_______________

7. PRO RATES DUE SELLER:

7.1 Prepaid Taxes/Assessments . . . . $_______________
7.2 Impound Account Balances . . . . $_______________
7.3 Prepaid Association Assessment . . . . $_______________
7.4 Prepaid Ground Lease . . . . $_______________
7.5 Unpaid Rent Assigned to Buyer . . . . $_______________
7.6 Other ___________________________________ . . . . $_______________
7.7 TOTAL PRO RATES DUE SELLER [Lines 7.1 to 7.6]. . . . . (+)$_______________

8. ESTIMATED PROCEEDS OF SALE: . . . . (=)$_______________

8.1 The estimated net proceeds at line 8 from the sale or exchange analyzed in this net sheet will be received in the form of:

a. Cash . . . . $_______________
b. Note secured by a Trust Deed. . . . . $_______________
c. Equity in Replacement Real Estate. . . . . $_______________
d. Other ________________________. . . . . $_______________

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: _____________, 20______	Date: _____________, 20______
Broker: ______________________________________	Seller's Name: ________________________________
Agent: _______________________________________	Signature: ____________________________________
Signature: ____________________________________	Signature: ____________________________________

Costs of sale as a material fact

A **material fact** is information which, if known to a client, might affect the client's decisions, such as a seller's decision to enter into a listing or accept an offer to buy.

If the information, such as sales expenses, closing costs or the net proceeds of a sale, is known to the seller, the listing agent has no obligation to disclose it. However, if the information may affect a decision to be made by the seller and the information about sales **costs is not fully known** to the seller or is **more readily available** to the listing agent than to the seller, the costs must be disclosed to the seller to meet the listing agent's obligations under his *special agency duties* owed to his client.

It is best to prepare and review a net sheet with a seller, regardless of whether the seller requests or even declines to review a net sheet. The time and effort needed to prepare a net sheet is a small premium to pay to assure the agreed fee is not attacked at the time of closing should the seller claim he thought he was to receive a greater amount as net proceeds.

Analyzing the net sheet estimates

A listing agent prepares a Good Faith Estimate (GFE) of Seller's Net Sales Proceeds, **first tuesday** Form 310, to inform his client about the expenses the seller will likely incur on the disposition of his real estate by sale.

The estimates entered on the form by the seller's broker or listing agent must be based on information **known** by them or **readily available** to them on the inquiry of others or on minimal investigation about each item of expense they anticipate the seller will incur. Thus, the figures entered as estimates reflect the listing agent's **honestly held belief** that the amounts estimated will likely be experienced by the seller.

Brokerage events triggering a listing agent's preparation of the net sheet and a review of its contents with the seller for the sale of property include:

- soliciting or entering into a seller's listing agreement;
- submitting a buyer's purchase agreement offer;
- entering into a counteroffer; and
- entering into an exchange agreement offer or acceptance.

The net sheet is used by a listing agent for the purpose of disclosing to the seller the crucial financial information surrounding expenditures required to:

- put the property in a condition attractive to the greatest number of prospective buyers;
- comply with local retrofit ordinances and current safety standards;
- eliminate defects and infestation; and
- provide the listing agent with reports for delivery to prospective buyers which contain information on the physical condition of the property, the nature of the property's location, the expenses of ownership and any other aspects regarding the integrity of the property that have a measurable impact on the property's value.

The GFE of Seller's Net Sales Proceeds form consists of four sections, each serving an entirely separate purpose in the setting of the amount of net proceeds to be received by a seller on a sale. The sections list:

- the **encumbrances** of record, including any improvement district bonds, trust deeds and possible abstracts of judgment or tax liens to be assumed, reconveyed or released;

- the **expenses** of a sale, including repair and renovation expenditures, fees for investigative reports and closing charges paid by the seller;
- **adjustments and prorates** for unpaid or prepaid items and any tenant deposits to be taken over by the buyer; and
- the **net proceeds** remaining after deducting all sales-related expenses, fees and charges, as well as the form of the net proceeds.

Preparing the seller's net sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Seller's Net Sales Proceeds – On Sale of Property, **first tuesday** Form 310, with which a seller's agent may prepare an estimate for an analysis of the costs the seller will likely incur in the preparation, marketing and sale of the property. The disclosure of this data to the seller is necessary for the seller to make an informed decision regarding whether to sell, and if so, on what terms and conditions.

Each instruction corresponds to the number given each item in the form.

*Editor's note — **Enter** figures throughout the net sheet in the blanks provided, unless the item is not intended to be included in the final estimate, in which case it is left blank.*

Document identification:

Enter the date and name of the city where the net sheet is prepared. The date is used when referring to this form.

1. **Check** the appropriate box to indicate the underlying agreement which is the subject of this disclosure. **Enter** the identification date, the name(s) of the parties to the underlying agreement, the address or parcel number identifying the property for sale, and the day of the month on which escrow is to close for pro rations and adjustments.

2. **Sales price:**

   2.1 *Price received:* **Enter** the amount of the sales price to be paid by the buyer.

3. **Encumbrances:**

   3.1 *First trust deed note:* **Enter** the dollar amount of the principal balance remaining due on any first trust deed loan of record as noted on loan payment records held by the seller, whether the loan is to be assumed or paid off on closing.

   3.2 *Second trust deed note:* **Enter** the dollar amount of the principal balance remaining due on any second trust deed loan of record as noted on loan payment records held by the seller, whether the loan is to be assumed or paid off on closing.

   3.3 *Other liens/bonds/UCC-1:* **Enter** the total dollar amount of the principal balance and any accrued unpaid interest on any judgment liens, tax liens and improvement district bond liens encumbering the property, and any UCC-1 liens on any personal property which are part of the sale, whether the liens will be assumed or paid off on closing.

Editor's note — Some purchase agreements, in their provisions for handling improvement district bond liens, omit any accounting on the transfer of title subject to a lien for the balance of an improvement district bond with annual installments. Annual installments on the improvement bond lien are treated in these

purchase agreements as pro rates of both the principal and interest installment amounts, without concern for an accounting of the principal balance which remains unpaid.

3.4 *Total encumbrances:* **Add** the figures entered in sections 3.1 through 3.3. **Enter** the total as the dollar amount of debts encumbering the property, whether assumed by the buyer or paid off on closing.

4. **Sales expenses and charges:**

4.1 *Fix-up cost:* **Enter** the dollar amount estimated to cover the costs it is anticipated the seller will incur to ready the property for previews by other agents, caravans, walk-throughs by prospective buyers and open house viewings, such as the cost to add color to the landscaping, paint outside trim and any interior walls showing wear and tear, and replace any plumbing or electrical fixtures which are beyond repair or of unacceptable appearance.

4.2 *Structural pest control report:* **Enter** the dollar amount of the fee a pest control operator will charge to conduct a physical inspection and submit a report on his findings and provide an estimate of the costs of repairs necessary to eliminate any infestation and repair any existing damage or condition allowing for infestation. These are property conditions most buyers do not want to acquire.

4.3 *Structural pest control clearance:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for fumigation or to correct damage from an infestation or conditions supporting an infestation. The amount estimated will need to be reviewed and updated on receipt of the structural pest control report.

Also, the amount estimated should be considered when setting any ceiling in a counteroffer on the costs the seller might be willing to incur to correct the adverse condition of his property.

4.4 *Property/home inspection report:* **Enter** the dollar amount of the fee a home inspection company will charge to conduct a physical inspection of the property and submit a report on their observations of defects existing on the property.

4.5 *Elimination of property defects:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur to eliminate, by repair or replacement, any conditions not up to building or safety codes, such as malfunctioning or defective components, e.g., the roof, electrical wiring, plumbing, heating, the foundation, walls, fences, doors, and appliances. The amount estimated will need to be reviewed and updated on receipt of a property/home inspection report.

Also, the amount estimated should be considered when setting any ceiling in an offer or counteroffer of the amount of costs the seller might be willing to incur to correct the condition of his property for transfer.

4.6 *Local ordinance compliance report:* **Enter** the dollar amount of the fee a local government agency charges to inspect the property and submit a report on its findings and the corrections required to be completed before transfer of ownership and occupancy may occur.

4.7 *Compliance with local ordinances:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for retrofitting, curative permits, and any repairs necessary

to meet local ordinance standards as a requisite to a change in ownership or occupancy. The amount estimated will need to be reviewed and updated on receipt of the local agency's compliance report.

4.8 *Natural Hazard Disclosure report:* **Enter** the dollar amount of the fee charged by a third party for a review of the county records and the preparation and submission of a report on the natural hazards the property is subjected to due to its location.

4.9 *Smoke detector/water heater safety compliance:* **Enter** the dollar amount of the cost it is anticipated the seller will incur to install smoke detectors and the water heater anchors or bracing which are necessary to comply with safety standards.

4.10 *Homeowners' association (HOA) document charge:* **Enter** the dollar amount of the fees charged by any owners' association connected to the property for their delivery of a complete marketing packet of documents comprised of restrictions, operations, budgets, insurance and other documents mandated to be handed to the prospective buyer, and their delivery to escrow of their statement of condition of assessments.

4.11 *Mello-Roos assessment statement charge:* **Enter** the dollar amount of the fee charged for a statement of assessments to be provided by any improvement district which holds a lien on the property to secure the repayment of bonds issued by the improvement district.

4.12 *Well water reports:* **Enter** the dollar amount of the combined fees which will be charged by a licensed well-drilling contractor to test and certify the capacity of any well on the property, and by a licensed water testing lab to test and report on the quality of the water produced by the well.

4.13 *Septic/sewer reports:* **Enter** the dollar amount of the fee charged by a licensed plumbing contractor to test and certify the function of the sewage disposal system, and if it contains a septic tank, whether it is in need of pumping.

4.14 *Lead-based paint report:* **Enter** the dollar amount of the fee charged by an environmental testing company to investigate and report on the lead content of paint on the premises.

4.15 *Marketing budget:* **Enter** the dollar amount of any contribution (to be) made by the seller toward the expenses of marketing the property and locating prospective buyers.

4.16 *Home warranty insurance:* **Enter** the dollar amount of the premium the seller agrees to pay as charged by a home warranty insurance company to issue a policy to the buyer.

4.17 *Buyer's escrow closing costs:* **Enter** the dollar amount of the combined escrow closing costs incurred by the buyer which the seller agrees to pay.

4.18 *Loan appraisal fee:* **Enter** the dollar amount of any loan appraisal fee the seller will agree to pay which will be charged to determine the property's qualification for the purchase-assist loan which will be applied for by the buyer.

4.19 *Buyer's loan charges:* **Enter** the dollar amount of any loan charges the seller will agree to pay which the buyer will incur for the purchase-assist loan needed to fund the price to be paid for the property. These loan charges are also referred to as non-recurring loan charges.

4.20 *Escrow fee:* **Enter** the dollar amount of the charge the seller will incur for escrow services to process the closing of the sale.

4.21 *Document preparation fee:* **Enter** the dollar amount of the charge the seller will incur, usually with escrow, for a third party to prepare the documents necessary for the seller to convey the property, such as grant deeds and bills of sale.

4.22 *Notary fees:* **Enter** the dollar amount of the charge the seller will incur for services provided by a notary to acknowledge the seller's signature on documents which are to be recorded to accomplish the transfer of the property (grant deed, spousal quit claim deed, release of recorded instruments, power-of-attorney, etc.).

4.23 *Recording fees/documentary transfer tax:* **Enter** the dollar amount of the combined recording charges and transfer taxes collected by the county recorder and paid by the seller to convey title.

4.24 *Title insurance premium:* **Enter** the dollar amount of the premium the title insurance company will charge for issuance of a policy of title insurance conveying the seller's conveyance of the property.

4.25 *Beneficiary statement/demand:* **Enter** the dollar amount of the combined fees the trust deed lender of record will charge for delivering a beneficiary statement or payoff demand to escrow which is needed to either confirm the loan balance on an assumption or subject-to transaction, or the amount of a payoff of the loan on closing a sale.

4.26 *Prepayment penalty (first):* **Enter** the dollar amount of any penalty the first trust deed lender will charge on a payoff of the loan on close of a sale.

4.27 *Prepayment penalty (second):* **Enter** the dollar amount of any penalty the second trust deed lender will charge on a payoff of the loan on close of a sale.

4.28 *Reconveyance fees:* **Enter** the dollar amount of reconveyance fees and recording fees the trustees on the trust deeds of record will charge to release the trust deed liens from the record title to the property sold.

4.29 *Brokerage fees:* **Enter** the dollar amount of the fees earned by the brokers which will be paid by the seller on the close of escrow for the sale of the property.

4.30 *Transaction coordinator fee:* **Enter** the dollar amount of the fee charged the brokers which the seller will pay for a third party to assist the listing agent in the preparation of the listing package and the sales package to provide all the documentation necessary to close the transaction.

4.31 *Attorney/accountant fees:* **Enter** the dollar amount estimated as the attorney fees and accounting fees the seller will incur as a result of their advice and assistance in the sale.

4.32 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.33 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.34 *Total expenses and charges:* **Add** the figures entered in sections 4.1 through 4.33 **Enter** the total as the dollar amount of the expenses and charges on the sale.

5. **Estimated net equity: Subtract** the figures entered in sections 4.4 and 4.34 from the figure entered at section 2.1 **Enter** the difference as the dollar amount of the estimated net equity, an amount against which s and adjustments are next made to calculate the estimated net sales proceeds generated by the sale.

6. **Pro rates due buyer:**

   6.1 *Unpaid taxes/assessments:* **Enter** the dollar amount of those real estate taxes and improvement district bond assessments which have accrued and have not been paid by the seller if they are to be pro rated without a credit to the price for the remaining principal due on bonds under section 3.3.

   Taxes have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the taxes which accrued during the seller's ownership will be paid by the buyer at a later date. Thus, taxes are pro rated as a credit to the buyer through the **last day prior** to the date of closing. The pro ration is calculated as a daily amount of the annual tax based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for up to 2% inflation, etc.) to arrive at the daily amount of the pro ration.

Editor's note — For example, if escrow is scheduled to close September 16, the tax billing has not yet been received and (if it has been) it has not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

   6.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on loans assumed under sections 2.1 through 3.3 for the number of days during the month the seller will remain the owner prior to closing. The pro ration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month. The daily amount of interest accruing is credited to the assuming buyer for each day of the month prior to the day scheduled for closing since interest on loans is paid after the running of the monthly accrual period. Thus, the current installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to each the seller and the buyer.

   6.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which will remain unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion as a pro ration. The day of closing is the first day of ownership by the buyer and entitles the buyer to unearned rents for the entire day. The pro ration is calculated as a daily amount of the rent roll earned (accrued) based on a 30-day month.

Editor's note — For example, if the rents are $30,000 monthly, the daily pro ration for earned rents would be $1,000 and be multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of pro rated rents credited to the buyer from funds accruing to the seller's account on closing would be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 7.5 for an offset charge to the buyer by an adjustment.

   6.4 *Tenant security deposits:* **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet.

This credit is an **adjustment in funds**, not a pro ration, which is due the seller on closing since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for the eventual accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

6.5 *Total pro rates due buyer:* **Add** the figures estimated in sections 6.1 through 6.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to pro rations and adjustments.

7. Pro rates due seller:

7.1 *Prepaid taxes/assessments:* **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 6.1.

Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on January 2 requires a pro ration charge to be paid by the buyer for one-half year's taxes and assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

7.2 *Impound account balances:* **Enter** the dollar amount of any impounds held by the lender on loans assumed under sections 3.1, 3.2 or 3.3. The information is readily available as an "escrow account" item on the lender's monthly statement of the loan's condition received by the seller from the lender servicing the loan.

7.3 *Prepaid association assessment:* **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any owners' association assessment. The pro ration charge is based on a 30-day month for those days remaining in the month beginning with the day of closing as day one of the days remaining in the month.

7.4 *Prepaid ground lease:* **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment, not a fee interest transferred by grant deed.

7.5 *Unpaid rent assigned to buyer:* **Enter** the portion of the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (Rents have been pro rated in section 6.3.)

7.6 *Miscellaneous pro rates and adjustments:* **Enter** the name of other items to be d or adjusted in the transaction. **Enter** the dollar amount charged to the buyer.

7.7 *Total pro rates due seller:* **Add** the figures estimated in sections 7.1 through 7.6. **Enter** the total as the dollar amount of all the "charges" the buyer is likely to experience due to pro rations and adjustments.

8. *Estimated proceeds of sale:* **Add** the figures in sections 5 and 7.7, and then **subtract** the figure in section 6.5 from the sum. **Enter** the difference as the total dollar amount of the estimated net proceeds generated by the sale.

    8.1 *Form of net sales proceeds:* **Enter** the dollar amount of the net sales proceeds estimated in section 6 allocated to cash, carryback note, equity received in exchange or other form of consideration the seller will be receiving on the sale.

Signatures:

Broker's/Agent's signature: **Enter** the date the seller's net sheet is signed, the broker's name and the agent's name. **Enter** the broker's (or agent's) signature.

Seller's signature: **Enter** the date the seller signs and the seller's name. **Obtain** the seller's signature.

Chapter 24 Buyer's estimated acquisition costs

This chapter presents the use of a checklist by a buyer's agent to identify, analyze, and disclose the funding requirements a buyer undertakes when agreeing to acquire property.

The capital to buy

During every real estate business cycle, a time comes when buyers collectively refuse or become unable to pay ever higher prices. Gone then are the back-up buyers and forgotten are the previously ever-present multi-offer auctions surrounding nearly every fresh listing of property.

Thus begins a multi-year descendency of real estate prices. The drop in prices is usually brought about by the end of a cyclical real estate bubble, evidenced by excessive asset inflation and low mortgage rates.

It is during this evolving buyer's market of descending prices and ever more anxious sellers that real estate agents have difficulty attracting buyers, either as clients they will represent or as prospective buyers of properties they have listed. For agents, a **clientele of buyers** becomes financially more rewarding during the transition into a buyer's market than a pile of property listings.

However, buyers are reticent about buying while this corrective phase of the real estate business cycle is taking place. With its soft prices and plentiful supply of inventory for buyers to consider, this **period of price correction** will eventually reflect sales-to-listing ratios indicating less than 25% of the existing listings are selling each month (with a bottom of less than 10% sold during the period of 2008 and 2009).

Agents generally face a decline in overall sales activity until prices stabilize and begin to rise. In the interim, the less ingenious and most disconnected agents will fail to maintain a livelihood in real estate sales. They will pursue employment elsewhere.

Disclosures as confidence builders

To reverse the trend in buyer apathy toward acquiring real estate during these corrective transitions, the "sales" approach used by agents needs to be altered. Buyers can no longer be rushed to purchase since they have no sense of urgency when prices are dropping. Valuations placed on properties by seller's now seem pricey to buyers, yet listing agents tend to defend against any thought of a price reduction as though their job was that of a "marketmaker," not "matchmaker."

Buyers under these market conditions will not **first jump** into a purchase agreement contract and sort out the facts later, conduct typical during the run up to the peak of a real estate sales bubble. They now want the **facts first**, and will not act until they have them.

To combat an oversold real estate market, sellers and their listing agents must be more forthcoming with property information when placing a property on the market, rather than stalling until they have a buyer in escrow at an agreed price.

Buyer's agents adjust more quickly than listing agents to the cyclical shift from a seller's market long on buyers to a buyer's market long on sellers and inventory. They simply marshall information on a property

and analyze it **before making an offer,** rather than doing so later as is too often the case when competition between buyers is keen.

To accommodate individuals who are hesitant about buying now, or to encourage others, such as tenants, who have not previously considered buying real estate, the initial step taken by an agent striving to become a buyer's representative is to **financially qualify** the individual as both a mortgage borrower and prospective buyer.

An individual buyer must have **access to cash** to pay the price and costs of acquiring property. Beyond the cash available in savings or readily liquidated investments (stocks/bonds), arranging purchase-assist mortgage financing is nearly always a requisite to establishing what price and costs of acquisition an individual will be able to pay.

With financing comes lender, mortgage banker and loan broker charges to originate the loan. Loan origination charges greatly exceed the costs of all other services required to buy property, except for brokerage fees.

Amount and source of funds

To document the cash a prospective buyer can bring together from all his available sources to **fund the purchase** of a property, the buyer's agent uses a worksheet, called a *buyer's cost sheet*. The worksheet helps the agent identify and itemize the estimated-in-good-faith costs of acquisition and financing, as well as the buyer's sources of funding. The buyer's agent then reviews the completed form with the prospective buyer. [See Form 311 accompanying this chapter]

The **maximum price** a prospective buyer can offer to pay for a property is determined by the amount of available funds from all sources which remains after deducting the acquisition costs. It is this residual amount of funds available for payment of a property's price which sets the value of a property to the buyer, not the seller's listing price. Sellers and their listing agents tend to ignore this reality as interest rates rise, but take full advantage of the rule when rates fall.

Obviously, the primary source of cash for nearly all buyers of any type of real estate is a purchase-assist loan from a mortgage lender. Before a cost sheet review with the buyer can go beyond identifying the various sources of cash available to the buyer, the agent must arrange a conference with a mortgage banker's representative.

The objective of the conference with a mortgage banker is two fold:

- to determine the maximum gross dollar amount of purchase-assist, fixed-rate loan funds the buyer will be *pre-approved* to borrow (if the property qualifies); and
- the lender's (good-faith) cost estimate of the dollar amount of all costs the buyer will incur to originate the maximum fixed-rate loan he is qualified to borrow.

These two dollar amounts (the loan and its costs) are treated as mutually exclusive amounts, separately analyzed on the buyer's cost sheet. The lender's estimated costs of borrowing will be entered on the agent's cost worksheet to document the amount of funds the buyer will need to pay for all transactional and financing costs. Separately, the total amount of the loan the buyer qualifies to borrow will be entered on the buyer's cost worksheet as cash available from a purchase-assist loan source.

During the conference with the mortgage banker, the buyer's agent needs to inquire about any restrictions the lender may place on the loan commitment. For example, a loan-to-value ratio may require a minimum down payment by the buyer of up to 20% of the price paid for a property.

Also, limitations might be placed on the seller's payment of the buyer's nonrecurring transactional and financing costs, such as permitting the seller's payment of all, a ceiling amount or none at all.

With knowledge of any lender restrictions, the buyer's agent can structure purchase agreement offers to shift large amounts of transactional and financing charges to the seller. Thus, the charges will be paid by the seller out of funds the seller receives from the buyer, not paid by the buyer, which would reduce the funds he has available to buy property. Here, the buyer can acquire a more valuable property since he will have more funds for payment of the purchase price.

Certainty of costs builds confidence to buy

Having determined the prospective buyer's costs of financing and the transactional charges he will incur to acquire a property, a high level of certainty about the price he can pay and the amount of the buyer's nonrecurring acquisition and financing costs he will incur is made known to the buyer. What remains for the buyer's agent to do is locate suitable properties and write up a purchase agreement offer agreeable to the buyer.

Buyers combat declining prices and alleviate their tendency to wait before buying by making an offer at a price they feel comfortable paying for a property. Thus, pricing is based on their knowledge the real estate market is in a descendency, the property's condition, and their capacity to arrange for payment of the negotiated price and bear the costs of financing and closing escrow.

The task of complying with the agent's duty to **care for and protect** the buyer begins with the gathering of data to complete the preparation of the cost sheet. The process ends by making offers to come up with the match the buyer wants.

Cost of carrying property

While a review of the costs of acquisition is under way, many other related disclosure situations will come to the attention of the buyer's agent.

For example, a separate cost analysis involves the ongoing **operating expenses** any buyer will likely incur as the owner of property. Operating expenses are obtained from the listing agent or compiled by the buyer's agent from data readily available to the seller, and reviewed with the prospective buyer. [See **first tuesday** Form 562]

Also, a drop in prices is usually a loss in the present worth of a property brought about by an increase in long-term interest rates. Prices and mortgage rates eventually move in opposite directions. Important to buyers during times of rising long-term interest rates is the understanding that the **price paid and costs** incurred to acquire property are *unalterable* in the future once escrow closes on the purchase.

This is not true for **interest rates**. A high interest rate on a loan required to finance payment of the purchase price of a property can be reduced by *refinancing* during later periods of cyclically lower interest rates. The original purchase price paid, if too high, is unalterable.

Reducing and shifting the costs

Taxwise, a further source of an additional minimal amount of cash to cover the costs of acquiring property is available to buyers who **itemize deductions** on their federal tax returns. Loan origination fees or points incurred to finance the purchase can be deducted (even if paid by the seller) to reduce the buyer's taxable income (and thus the amount of taxes paid) for the year of purchase. As a result, more funds are freed by a tax refund (or reduced payment).

GOOD FAITH ESTIMATE OF BUYER'S ACQUISITION COSTS

On Acquisition of Property

NOTE: This cost sheet is prepared to assist the buyer to estimate the total cost of acquisition for a property to anticipate the amount of funds likely needed to close, and the source of these funds.

The figures estimated in this cost sheet may vary at the time of closing due to periodic changes in lender demands, escrow fees, other charges and prorates, and thus constitute an opinion, not a guarantee of the preparer.

If acquiring IRC §1031 replacement property, also use a §1031 Profit and Basis Recap Sheet to compute the income tax consequences of the transaction. [See **ft** Form 354]

DATE: _____________, 20______, at ____, California.

1. This is an estimate of acquisition costs and the funds required to close the following transaction:
☐ Purchase Agreement ☐ Exchange agreement ☐ Counteroffer ☐ Escrow Instructions ☐ Option

1.1 entered into by ____,

1.2 dated _____________, 20______, at ____, California,

1.3 regarding real estate referred to as ____

____.

2. EXISTING FINANCING ASSUMED:

2.1 First Trust Deed of Record . . . . $_______________

2.2 Second Trust Deed of Record . . . . $_______________

2.3 Other Encumbrances/Liens/Bonds . . . . $_______________

2.4 TOTAL Encumbrances Assumed [lines 2.1 to 2.4] . . . . (+)$_______________

a. If loan balance adjustments are to be made in cash, the total funds required to close escrow at §10 and §12 will vary.

3. INSTALLMENT SALE FINANCING:

3.1 Seller Carryback Financing . . . . (+)$_______________

4. NEW FINANCING ORIGINATED:

4.1 New Loan Amount . . . . (+)$_______________

4.2 Points/Discount . . . . $_______________

4.3 Appraisal Fee . . . . $_______________

4.4 Credit Report Fee . . . . $_______________

4.5 Miscellaneous Origination Fees . . . . $_______________

4.6 Prepaid Interest . . . . $_______________

4.7 Mortgage Insurance Premium . . . . $_______________

4.8 Lender's Title Policy Premium . . . . $_______________

4.9 Tax Service Fee . . . . $_______________

4.10 Loan Brokerage Fee . . . . $_______________

4.11 Other ____ . . . . $_______________

4.12 TOTAL New Financing Costs [lines 4.2 to 4.11] . . . . (+)$_______________

5. PURCHASE COSTS AND CHARGES:

5.1 Assumption Fees (First) . . . . $_______________

5.2 Assumption Fees (Second) . . . . $_______________

5.3 Escrow Fee . . . . $_______________

5.4 Notary Fee . . . . $_______________

5.5 Document Preparation Fee . . . . $_______________

5.6 Recording Fee/Transfer Taxes . . . . $_______________

5.7 Title Insurance Premium . . . . $_______________

5.8 Property Condition Reports . . . . $______________

5.9 Cost of Compliance Repairs . . . . $______________

5.10 Other ____ . . . . $______________

5.11 Other ____ . . . . $______________

5.12 TOTAL Closing Costs [lines 5.1 to 5.11]. . . . . (+)$______________

5.13 Down Payment on Price . . . . (+)$______________

6. TOTAL ESTIMATED ACQUISITION COST [lines 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13] . . . . . (=)$______________

6.1 No post-closing repairs or renovation cost are included here.

7. FUNDS REQUIRED TO CLOSE ESCROW:

7.1 Down Payment On Price (From line 5.13) . . . . (+)$______________

7.2 Closing Costs (From line 5.12) . . . . (+)$______________

7.3 New Loan Proceeds (From line 4.1) . . . . (+)$______________

7.4 New Financing Costs (From line 4.12) . . . . (+)$______________

7.5 Impounds for New Financing . . . . (+)$______________

7.6 Hazard Insurance Premium . . . . (+)$______________

8. PRORATES DUE BUYER AT CLOSE:

8.1 Unpaid Taxes/Assessments . . . . $______________

8.2 Interest Accrued and Unpaid . . . . $______________

8.3 Unearned Rental Income . . . . $______________

8.4 Tenant Security Deposits . . . . $______________

8.5 TOTAL Prorates Due Buyer [lines 8.1 to 8.4] . . . . (-)$______________

9. PRORATES DUE SELLER AT CLOSE:

9.1 Prepaid Taxes/Assessments . . . . $______________

9.2 Impound Account Balance . . . . $______________

9.3 Prepaid Homeowners' Assessment . . . . $______________

9.4 Prepaid Ground Lease Rent . . . . $______________

9.5 Unpaid Rents assigned to Buyer . . . . $______________

9.6 Other _______________________________________ . . . . $______________

9.7 TOTAL Prorates Due Seller [lines 9.1 to 9.6] . . . . (+)$______________

10. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: [lines 7.1 to 7.6, less 8.5 plus 9.7]. (=)$______________

10.1 See §2.4.a. adjustments.

11. SOURCE OF FUNDS REQUIRED TO CLOSE ESCROW:

11.1 New First Loan Amount (From line 4.1) . . . . $______________

11.2 New Second Loan Amount (Net loan proceeds). . . . . $______________

11.3 Third-Party Deposits . . . . $______________

11.4 Buyer's Cash . . . . $______________

12. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: (Same as line 10) . . . . (=)$______________

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: ______________, 20______	Date: ______________, 20______
Broker: ________________________________	Buyer's Name: ________________________________
Agent: ________________________________	Signature: ________________________________
Signature: ________________________________	Signature: ________________________________

For example, payment to the lender of 2% of the loan amount for **origination fees** will produce a rebate (or subsidy) to the buyer by way of a reduction in federal income taxes equal to 1/3 to 2/3 of a percent of the purchase price paid for the property. The amount of the refund depends on the buyer's low-income (10%-15%) or high-income (28%-35%) tax bracket status and the amount of the buyer's adjusted gross income.

Also, buyers who finance their purchase under government-insured finance programs can attend **homeownership classes** and earn credits which will cut their costs of acquiring financing. In a buyer's market, potential first-time buyers, such as tenants, can be encouraged to consider homeownership by attending one of these lender-provided classes. The purpose is to learn about the benefits and obligations of owning real estate. The financing costs charged by the lender will be reduced when the prospective buyers decide to purchase after completing such a course.

Sellers, in an effort to maintain price, often are willing to extend credit in some form of **carryback financing,** a method for the buyer to finance the purchase price. For a buyer, seller carryback financing avoids all the costs of new financing.

If the **interest rate** charged by the seller on the carryback is low enough (below market), the price paid can be above market. The buyer's reduced long-term carrying costs arguably justify payment of the above-market price, one offsetting the other based on the dollar amount saved in interest. However, the buyer should always ask for, and hopefully receive, an option to pay off the carryback early and at a discount to keep the purchase price realistic should the buyer later decide to sell or refinance the property.

During the early stages of a buyer's market, and continuing until prices bottom out and become stable, buyers who make offers must be prepared to have their offers rejected. Historically, sellers and listing agents are slow to acknowledge that prices have in fact stopped rising on comparable properties.

When sellers finally recognize that market values are declining, they tend to panic by accepting huge price reductions. At some point they realize that buyers are entering the market in increasing numbers and the bottom of the price cycle has arrived.

Once buyers become addicted to the possibilities of price and cost reductions, buyer's agents will need to be ever more creative to keep costs down as sales volume increases. One maneuver for shaving a sizeable dollar amount off the price of property is for buyer's agents to track suitable properties by the date the listing expires. On expiration of the listing, an inquiry of the seller by the buyer's agent for the sole purpose of submitting an offer, not for soliciting a dual agency listing, is likely to open up a price advantage for the buyer.

Here, the advantage for the buyer amounts to a price paid of around 3% less for the property (than the previously listed price). The buyer's agent will still receive the same amount for a fee as he would have received had a higher price been paid under a listing and the brokerage fee been shared with the listing agent (who did not locate a buyer).

Motivating individuals to own

The objective of agents in a buyer's market of declining prices, increasing inventory and fewer sales is to **create buyers**, not sales.

No longer can agents concentrate primarily on listing property and be successful. Primary attention must now be given to potential and prospective buyers, to educate them and demonstrate why they should be represented by a buyer's agent.

Thus, **locating buyers** is no longer best accomplished by listing and marketing property for sale. Individuals who are qualified to be a buyer of real estate must be attracted to the market by inducements other than publishing property listings and holding auctions or open houses.

Most potential buyers are tenants occupying apartments, condominium units or single-family residences. They have a job and thus can qualify for a purchase-assist loan to enter into ownership. These tenants are sought out by agents through business, social, civic, athletic and religious networks.

New arrivals to the community should be contacted by advertisements located in airports, train stations and bus terminals to convert the new arrivals to homeownership. A kiosk in a shopping mall (or airport) manned by an agent might solicit tenants to fill out a homeownership application for the agent to review and advise on the homeownership available to the tenant.

Finally, the issue of the agent's need to enter into an **employment agreement** before the agent undertakes the representation of an individual needs to be addressed.

Whether the need for a written employment is broached with the potential buyer **before making** a thorough loan qualification analysis and a review of the costs of acquisition or **afterward**, when the prospective buyer's financial capability and price range have been established, a buyer's listing agreement certainly should be obtained before commencing a search for qualified properties the buyer might deem suitable to own.

Analyzing the cost sheet estimates

The Good Faith Estimate of Buyer's Acquisition Costs, **first tuesday** Form 311, is used by buyer's brokers and their agents to inform a prospective buyer about the cost of acquiring a particular parcel of real estate they have located and feel is suitable for acquisition by the buyer. The form contains a checklist of bookkeeping items typical of most purchases, including acquisition costs, financing charges, prorations, funds required for acquisition and the buyer's probable sources for these funds.

The **estimates** entered on the form by the buyer's agent must be based on information about transactional costs and financing charges both known to him or readily available to him on an inquiry of others or on minimal investigation. Thus, the figures entered must reflect the agent's **honestly held belief** that the estimated amount will likely be experienced by the buyer should the buyer acquire the property under consideration.

The cost sheet is used to disclose the crucial **financial information** the buyer needs to know about the acquisition of a property. With it, the buyer's agent provides the buyer with a high level of **transparency** about the costs of acquisition. Thus, the prospective buyer is able to make an informed decision about the financial commitment needed to purchase the property.

The events triggering the buyer's agent's preparation of a cost sheet and a review of the costs with the prospective buyer include:

- entering into a buyer's listing agreement;
- pre-qualifying for a maximum loan amount; and
- entering into a purchase agreement offer or accepting a counteroffer.

The cost sheet is also used to **solicit tenants**, residential or nonresidential, to consider the purchase of property. With it, the agent can demonstrate whether the tenant has the financial capability to occupy a comparable property as an owner instead of as a tenant, be it a home or business premises.

Each section in Form 311 has a separate purpose. The sections cover:

- the **acquisition costs** of the property (cost basis);
- the **closing charges** (including prorations and adjustments); and
- the buyer's **source of funds** (savings, gifts, loans, etc.).

Preparing the buyer's cost sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Buyer's Acquisition Costs – On Acquisition of Property, **first tuesday** Form 311, with which the buyer's broker and his agent can prepare an estimate for an analysis of the buyer's ability to pay the price and all the costs and charges related to the purchase.

Each instruction corresponds to the provision in the form bearing the same number.

Editor's note — ***Enter*** *figures throughout the cost sheet in the blanks provided, unless the items left blank are not intended to be included in the final estimate.*

Document identification:

Enter the date and name of the city where the cost sheet is prepared. This date is used when referring to this form.

1. **Check** the appropriate box indicating the underlying agreement which is the subject of this disclosure of costs.

   1.1 **Enter** the name(s) of the parties to the agreement.

   1.2 **Enter** the date of the agreement and place of preparation.

   1.3 **Enter** the address or parcel number identifying the property involved.

2. **Existing financing assumed:**

   2.1 *First trust deed of record:* **Enter** the dollar amount of the first trust deed loan balance if the buyer is to take over the loan.

   2.2 *Second trust deed of record:* **Enter** the dollar amount of the second trust deed loan balance if the buyer is to take over the loan.

   2.3 *Other encumbrances/liens/bonds:* **Enter** the dollar amount of the principal balance remaining on any other money obligations which the buyer is to take over, such as liens for improvement district bond assessments (Mello Roos, 1915 Act, etc.), abstracts of judgment, UCC-1 security agreements (on personal property/improvements included in the purchase) or other debts to be assumed by the buyer.

   2.4 *TOTAL encumbrances assumed:* **Add** the figures estimated in sections 2.1, 2.2 and 2.3. **Enter** the total as the dollar amount of the principal balance on debts to be assumed or otherwise taken over by the buyer as part of the price.

      a. *Funds to close escrow will vary*: Each estimated figure may vary by the time of closing, depending on the accuracy of the estimates, principal reduction on existing loans and changing service charges, fees and premiums. Also, if the difference in amounts is to be

adjusted into the cash down payment, the amount of funds required to close escrow at sections 10 and 12 will vary. Adjustments into price, such as in an equity purchase transaction, merely adjust the total consideration paid to the seller, not the amount of the down payment or any carryback note and trust deed. Likewise, adjustments for the differences into any seller carryback leaves the price and down payment unaffected, but will alter the amount of the carryback note at section 3.1 by the time escrow closes.

3. **Installment sale financing:**

3.1 *Seller carryback financing:* **Enter** the dollar amount of the note the buyer is to execute in favor of the seller. This amount will vary if adjustments at closing are to be made into the carryback note, and not into the down payment or the price.

4. **New financing originated:**

4.1 *New loan amount:* **Enter** the dollar amount of the new trust deed loan the buyer is to originate with a lender to provide purchase-assist funds to close escrow. The total amount of the loan is entered without reduction for any lender discounts, costs, fees or charges.

4.2 *Points/discount:* **Enter** the dollar amount of the points to be paid or the discount charged to originate the new loan, a figure usually calculated as a percentage of the new loan amount.

4.3 *Appraisal fee:* **Enter** the dollar amount the new lender will charge for an appraisal of the property to be purchased. Upon request, the buyer is entitled to a copy of the appraisal from the lender. [See **first tuesday** Form 200-3]

4.4 *Credit report fee:* **Enter** the dollar amount of the credit report fee charged by the lender for ordering the report and analyzing the buyer's creditworthiness.

4.5 *Miscellaneous origination fees:* **Enter** the total dollar amount of all other fees charged by the lender to process the loan, including fees labelled as escrow set-up fees, administrative fees, processing fees, origination fees, wire fees, document preparation fees, etc., which are **not itemized** in sections 4.2 through 4.11.

4.6 *Prepaid interest:* **Enter** the dollar amount of prepaid interest the new lender will demand for closing before the last day of the calendar month. The interest charge will be a daily amount due for each day following closing through the last day of the month in which the sale closes. This prepayment of interest allows for the first installment on the loan to be due on the first day of the first month falling more than 30 days after closing.

4.7 *Mortgage insurance premium:* **Enter** the dollar amount of any private mortgage insurance (PMI), mortgage insurance premium (MIP) or other insurance premium to be paid by the buyer to guarantee payment for losses the lender may suffer on a default. The amount is a quote by a corporate or government insurer based on the loan-to-value ratio and the amount of the loan. A further creditworthiness risk review of the buyer is conducted by the insurer, which could alter the premium or the availability of the insurance.

4.8 *Lender's title policy premium:* **Enter** the dollar amount of the premium charged by the title company to issue a separate lender's policy of title insurance (in addition to the owner's policy at section 24) to cover the existence of the security interest in the property as evidenced by the lender's trust deed lien.

4.9 *Tax service fee:* **Enter** the dollar amount charged by a separate service company which informs the lender when the buyer has not paid the property taxes.

4.10 *Loan brokerage fee:* **Enter** the dollar amount of any fees due a loan broker for arranging the new loan for the buyer. Do not include any financial benefit (kickback/referral fee) paid the brokers or sales agents by the lender since they are paid from increased fees or above-market interest rates the lender charges the buyer.

4.11 *Miscellaneous loan charges:* **Enter** the name of any other loan charge to be incurred by the buyer due to the new loan origination. **Enter** the dollar amount of the charge.

4.12 *TOTAL new financing costs:* **Add** the figures estimated in sections 4.1 through 4.11. **Enter** the total as the dollar amount of all the expenditures anticipated to be incurred by the buyer to originate a new loan.

5. **Purchase costs and charges:**

5.1 *Assumption fees (first):* **Enter** the dollar amount of the anticipated assumption fees the existing first trust deed lender will likely demand if the lender's consent is required for the buyer to take over the loan.

5.2 *Assumption fees (second):* **Enter** the dollar amount of the anticipated assumption fees the existing second trust deed lender will likely demand if the lender's consent is required for the buyer to take over the loan.

5.3 *Escrow fee:* **Enter** the dollar amount of the service charge the buyer will incur for an escrow to handle the closing of the purchase agreement.

5.4 *Notary fee:* **Enter** the dollar amount of the charges the buyer will incur for notary services to acknowledge the buyer's signature on documents which are to be recorded to purchase the property (trust deeds, power of attorney, spousal quit claim deeds, declaration of homestead, release of recorded instruments, request for NOD/NODq, UCC-1 filing, etc.).

5.5 *Document preparation fee:* **Enter** the dollar amount of any additional miscellaneous fees charged by escrow for providing escrow-related services.

5.6 *Recording fee/transfer taxes:* **Enter** the dollar amount of charges imposed or collected by the county recorder and paid by the buyer for recordings which are necessitated by the transfer.

5.7 *Title insurance premium:* **Enter** the dollar amount of the title insurance premium the title company will charge for issuing a policy to the buyer if the buyer is to pay the premium. Typically, the seller pays the premium to acquire the insurance which covers the seller's conveyance to the buyer.

5.8 *Property condition reports:* **Enter** the total dollar amount of fees and charges it is anticipated the buyer will incur to investigate and confirm the condition of the property (its land, improvements and components) as known to the buyer by both the buyer's observations and disclosures made by the seller or the listing agent prior to entering into the purchase agreement.

*Editor's note — The seller's broker or listing agent has a statutory duty, owed to prospective buyers on the sale of one-to-four residential units, to personally conduct a **visual inspection** of the property and enter on the mandated seller's Transfer Disclosure Statement (TDS) any **observations** he may have*

contrary to the seller's disclosures. The TDS is to be made available to prospective buyers at the earliest opportunity during the negotiating stage. The first opportunity to disclose rarely occurs later than at the time a purchase agreement offer is accepted.

However, the listing agent too often deliberately delays an investigation or certification of a property's condition until after the buyer has committed himself to purchase the property (in its undisclosed condition). Thus, the buyer, in a effort to confirm the property is all he has been lead to believe it is, must himself obtain the reports and certifications to discover the conditions which were known (or should have been known) and not disclosed by the seller or the listing agent prior to entering into the purchase agreement, a form of fraud called ***negative deceit.***

Such reports, clearances and certificates include pest control reports, local occupancy certificates, sewer/septic certificates, home inspection reports, well water condition certificates, hazard reports, safety compliances, etc. It is the buyer's agent, not the seller's listing agent, who is duty bound to see to it his buyer has been informed about inspections and investigations readily available to the buyer, and explain which he believes the buyer should use to check out the property.

5.9 *Cost of compliance repairs:* **Enter** the dollar amount of the costs it is anticipated the buyer will incur to correct, retrofit or eliminate defects in the property prior to or immediately after closing, which will not be eliminated by the seller.

5.10 *Miscellaneous closing costs:* **Enter** the name of any additional costs it is anticipated or believed the buyer will incur to acquire the property prior to or immediately after closing. **Enter** the dollar amount estimated as likely to be incurred.

5.11 *Miscellaneous closing costs:* See instructions for section 5.10.

5.12 *TOTAL closing costs:* **Add** the figures estimated for sections 5.1 through 5.11. **Enter** the total as the dollar amount of all costs it is anticipated the buyer will incur to close escrow.

5.13 *Down payment on price:* **Enter** the dollar amount of the down payment the buyer has agreed to pay the seller through or outside of escrow, whether the funds are from the buyer's cash reserves, gifts and bonuses from third parties, or a brokerage fee credited to the buyer's account due to the buyer's participation as a licensee in the transaction.

Editor's note — This sum of money for the down payment does not include any loan funds to be paid over to the seller from the new loan under section 4.1, or charges, prorations and adjustments reflected in section 10.

6. **Total estimated acquisition cost: Add** the figures from sections 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13. **Enter** the total as the approximate dollar amount of monetary commitments in cash or loan amounts which the buyer will be committing himself to pay.

6.1 *Post-closing repairs:* This cost figure does not include any capital contribution to be made by the buyer to pay for the cost of any renovation, rehabilitation or reconstruction of any part of the property to be incurred immediately after closing, which will become part of the buyer's cost of acquisition for tax reporting purposes.

7. **Funds required to close escrow:**

7.1 *Down payment on price:* **Enter** the dollar amount from section 5.13.

7.2 *Closing costs:* **Enter** the dollar amount from section 5.12.

7.3 *New loan proceeds:* **Enter** the dollar amount from section 4.1.

7.4 *New financing costs:* **Enter** the dollar amount from section 4.12.

7.5 *Impounds for new financing:* **Enter** the dollar amount of the deposit of buyer's funds into the lender's loan escrow account the lender will demand if the new loan under section 4.1 is to be impounded for the future payment of property taxes, assessments and hazard insurance premiums.

Editor's note — When disbursed by the lender, these expenditures from the impound account become the operating expenses of the buyer. They are not, now or then, a cost of acquiring the property (but are nonetheless an out-of-pocket advance made prior to closing).

7.6 *Hazard insurance premium:* **Enter** the dollar amount of the premium the buyer will be advancing for hazard insurance coverage on the property.

Editor's note — This is not a cost of acquisition. It is an operating expense.

8. **Prorates due buyer at close:**

8.1 *Unpaid taxes/assessments:* **Enter** the dollar amount of those real estate taxes and improvement district bond assessments which have accrued and have not been paid by the seller if they are to be prorated and are not credited to the price under section 2.3.

They have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the buyer will at a later date be paying those property taxes which accrued during the seller's ownership. Thus, they are prorated as a credit to the buyer through the last day prior to the date of closing. The proration is calculated as a daily amount of the annual tax and assessment amounts based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for inflation, etc.) to arrive at the daily amount of the proration.

Editor's note — If escrow is scheduled to close September 16, the tax billing has not yet been received and the current taxes have not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

8.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on loans assumed under sections 2 through 2.3 for the number of days during the month the seller will remain the owner prior to closing. The proration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month. The daily amount of interest accrued is credited to the buyer for each day of the month prior to the day scheduled for closing since interest on loans is paid following the month of accrual. Thus, the next installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to the seller and the buyer.

8.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which remains unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion of rent as a proration. The day of closing is the

first day of ownership by the buyer and entitles the buyer to unearned rents for the entire day on which escrow closes. The proration is calculated as a daily amount of the rent roll unearned based on a 30-day month.

Editor's note — If the rents are $30,000 monthly, the daily proration for earned rents would be $1,000, which is multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of prorated rents credited to the buyer from funds accruing to the seller's account on closing would be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 9.5 for an offset charge to the buyer by an adjustment.

8.4 *Tenant security deposits:* **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet. This credit is an *adjustment*, not a proration, in funds due the seller since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

8.5 *TOTAL prorates due buyer at close:* **Add** the figures estimated in sections 8.1 through 8.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to prorations and adjustments.

Editor's note — The debits charged to the buyer by proration are calculated in the following sections.

9. **Prorates due seller at close:**

9.1 *Prepaid taxes/assessments:* **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 8.1.

9.2 Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on December 31 requires a proration charge to be paid by the buyer for one-half year's (180 days') taxes/assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

9.3 *Impound account balance:* **Enter** the dollar amount of the impounds held by the lender on each loan assumed under sections 2.1, 2.2 or 2.3. The information is readily available from the monthly accounting of the loan's condition received by the seller from the lender servicing the loan.

9.4 *Prepaid homeowners' assessment:* **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any homeowners' association (HOA) assessment. The proration charge is based on a 30-day month for those days remaining in the month, beginning with the day of closing as day one of the days remaining in the month.

9.5 *Prepaid ground lease rent:* **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment and not a fee interest transferred by grant deed.

9.6 *Unpaid rents assigned to buyer:* **Enter** the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (All rents have been prorated in section 8.3.)

9.7 *Miscellaneous prorates and adjustments:* **Enter** the name of other prorates or adjustments which may be required. **Enter** the dollar amount charged to the buyer.

9.8 *TOTAL prorates due seller:* **Add** the figures estimated in sections 9.1 through 9.6. **Enter** the total as the dollar amount of all the "charges" the buyer is likely to experience due to prorations and adjustments.

10. **Total funds required to close escrow**:

Add the figures from sections 6, 7.1 through 7.6, 9.7, and then **subtract** the figure from section 8.5 from the total. **Enter** the difference as the dollar amount of funds the buyer will need to close escrow.

10.1 See section 2.4a adjustments.

11. **Source of funds required to close escrow:**

11.1 *New first loan amount:* **Enter** the dollar amount of the new loan estimated in section 4.1.

11.2 *New second loan amount:* **Enter** the dollar amount of any second trust deed loan to be originated. If the costs of originating the second have not been entered in section 4.2 through 4.12, then **enter** only the estimated amount of the net proceeds generated by the second loan here.

11.3 *Third-party adjustments:* **Enter** the dollar amount of any funds received from third parties which the buyer expects to use to fund the purchase of the property. For example, families make gifts, employers give bonuses and equity sharing and other co-ownership arrangements contribute cash.

11.4 *Buyer's cash:* **Subtract** the figures in sections 11.1 through 11.3 from the figure in section 10. **Enter** the result as the dollar amount of funds the buyer needs to presently hold or have in reserves (savings/readily convertible securities and certificates) to meet the expenditures anticipated by the estimates in this opinion given by the buyer's broker or his selling agent.

12. **Total funds required to close escrow**:

Add the figures estimated in sections 11.1 through 11.4. **Enter** the total as the amount of funds needed by the buyer to acquire the property.

Editor's note — The amount here in section 12 will be the same as the amount arrived at in section 10.

Signatures:

Broker's/Agent's signature: **Enter** the date the cost sheet is signed, the broker's name and the agent's name. **Obtain** the broker's (or agent's) signature.

Buyer's signature: **Enter** the date the buyer signs and the buyer's name. **Obtain** the buyer's signature.

Chapter 25 Contingency provisions

This chapter highlights the inclusion of contingency provisions in purchase agreements to allow buyers and sellers to either confirm their expectations and meet objectives or avoid closing the transaction.

Conditioning the close of escrow

The contents of a purchase agreement is a collection of provisions generally called terms and conditions. While **terms** focus on the price and the (terms for) payment of the price, **conditions** address:

- the *performance* of acts by the buyer and seller respectively; and
- *occurrence of events* in the process of closing escrow on the transaction.

Thus, each condition addressed in a provision must either be shown to exist or come into existence, by its occurrence or approval, before the purchase agreement can be enforced and escrow closed. Alternatively, the condition can be *waived* as though never part of the purchase agreement.

Thus, all purchase agreements contain one or more provisions "conditioning" closing on the "elimination of a contingency."

When conditions are the subject of *contingency provisions*, the **conditions** are initially distinguished by whether they:

- do *occur* (events and activities), called *event-occurrence contingencies*; or
- are *approved* (information, data, documents and reports), called *further-approval* or *personal-satisfaction contingencies*.

These **contingency provisions** grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement should an identified activity or event fail to occur or a condition be disapproved.

Also, provisions containing **conditions** are further classified by the sequence or order in which they will be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a *condition precedent* to the performance of an activity by the other person; or
- a *condition concurrent* to be performed without concern for the other person's activities.

Categorizing conditions still further, some conditions **must be performed**, making the failure to perform them and close escrow a *breach* of the purchase agreement. Other conditions are the subject of contingency provisions and **might not occur or be approved**, in which case the failure of one or both parties to further perform and close escrow is *excused*.

Thus, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an **option** to "do away with" any further performance of the purchase agreement and escrow instructions, called *cancellation*.

Conditions precedent and concurrent

While all contingency provisions are conditions, it must be well understood that not all conditions agreed to in the provisions of a purchase agreement are contingencies. Contingency provisions authorize the cancellation of the purchase agreement and *excuse* any further performance. Other conditions must be met since they are not contingencies, in which case a failure becomes a *breach*.

For analysis, the two classifications of conditions which exist in purchase agreements, distinguished by whether or not the other person must perform or is excused due to the failure of the identified event to occur or condition (information) to be approved, are:

1. *Conditions precedent*, which consist of contingency provisions calling for the occurrence or approval of an event or condition which **may or may not occur**. Examples include the buyer obtaining a written loan commitment, the recording of a purchase-assist loan, approving due diligence investigations, etc. Here, the contingency provision may be *eliminated* and the transaction can proceed toward closing. Alternatively, if the event or approval is not forthcoming, the person authorized to cancel may *exercise* his right to terminate the transaction, doing away with any **further performance** of the purchase agreement and escrow instructions, called *cancellation*; and
2. *Conditions concurrent*, which consist of noncontingent, mandatory performance provisions calling for the buyer or seller to perform some activity which **must occur**. If the activity does not occur, the purchase agreement has been *breached* by the person who promised to perform or was obligated to cause the activity or event to come about. Examples include the failure of the seller to produce promised information, data, documents and reports on the property or deliver a clearance, grant deed or title insurance policy as agreed. The failure to deliver is a *breach* which allows the other person to either terminate the transaction by notice of cancellation or pursue specific performance of the purchase agreement.

Before escrow can proceed on to closing, contingency provisions must be *eliminated*. Contingency provisions (conditions precedent) included in purchase agreements are **eliminated** by either:

- *satisfaction* of the condition by either an **approval** of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the **occurrence** of the event called for in the provision; or
- *waiver* (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified condition or event has not been satisfied by its approval or occurrence.

Thus, the buyer or seller who does not have the right to terminate the transaction under a provision and avoid closing the transaction must perform all his remaining obligations on the contract, called *conditions concurrent*. He must act without concern for the other person's performance under the purchase agreement, unless the other person must first perform some activity before he is able to comply. For example, the seller providing a Natural Hazard Report before the buyer can review it and approve its contents. [See **first tuesday** Form 150 §11.5]

The obligation of a buyer or seller to complete noncontingent (concurrent) activities required of him to close escrow exists in spite of the fact the other person may not have yet fully performed, or that the other person has a right to later cancel the purchase agreement. Examples include the inability of a buyer to originate a purchase-assist loan (or cancel) after the seller has fully performed by delivering all closing documents to escrow.

Content of a contingency provision

Regardless of the type of contingency involved, agents must make sure the contingency provision is in writing, even though oral contingencies are generally enforceable. Written contingencies avoid confusion over content, enforceability and forgetfulness.

Specifically, a written contingency should include:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision must occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller or both can enforce the contingency provision by canceling the transaction);
- any arrangements to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

Provisions for uncertainties

An agent includes contingency provisions in a purchase agreement in an effort to protect his client from agreeing absolutely to do or cause to occur that which may not occur. The goal at closing is to avoid being forced to accept a situation inconsistent with the client's original expectations or ability to perform when he entered into the purchase agreement.

Without **authority to terminate** the agreement on the failure of the client's expectations, such as the buyer's inability to record a purchase-assist loan or to confirm the seller's representations, the client's inability or refusal to continue to further perform under the purchase agreement and close escrow would be a *breach*. Thus, the client due to his breach would be liable to the other person, unless the client's nonperformance was justified by some pre-contract misrepresentation (or omission) of facts which led to the client's lost expectations, called *deceit*.

To avoid a **breach** and be **excused** from closing escrow an exit strategy must be agreed to in the purchase agreement. When events and conditions develop during escrow which do not meet the expectations or anticipations of the client, his agent must have foreseen the need to *conditionalize* the client's continued performance by including contingency provisions in the purchase agreement.

Due to the inclusion of a contingency provision, the client is **authorized to terminate** the agreement and avoid closing escrow on failure of the identified event to occur or due to the unacceptability of data, information, documents or reports. [See Form 159 §11 accompanying Chapter 22]

But before lacing a purchase agreement with contingency provisions, or allowing the client to enter into one, a prudent agent will first attempt to clear uncertainties the client may have about the property or the transaction before entering into the contract.

Use of contingency provisions

It is the buyer's agent who, along with buyers, is the primary user of contingency provisions in purchase agreements. From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to approve or cause to occur prior to closing should be the subject of a contingency provision in the purchase agreement. [See **first tuesday** Forms 260 through 279]

Also for buyers, the period for exercise of the right to cancel should be as long as possible. Thus, the right to cancel should be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow may never occur.

These conditions range, for example, from applying for purchase-assist financing or retaining consultants for advice on the value or integrity of the property, to making the down payment or providing personal identity information to the title insurance company.

When preparing the purchase agreement, the buyer's agent must rely on his experience to decide which events and approvals the buyer is responsible for and thus need to be the subject matter of a contingency provision. Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, he can act to avoid closing and not be in default (breach) on the purchase agreement (or end up in a dispute claiming he has been misled by the seller or the listing agent).

Many events and disclosures are the subject of contingency provisions contained in stock forms used by agents. [See Form 159 §11]

However, the boilerplate wording of pre-printed contingency provisions varies greatly regarding:

- the time for the gathering and delivery of data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);
- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party may then cancel;
- the requirement of a written notice of cancellation should the right to cancel be exercised on failure of an event or condition; and
- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Typically, several contingency provisions are included in a purchase agreement. Thus, a **uniform method** for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See Form 150 §10.5]

Also, approval notices or waiver of contingency provisions need not be called for in purchase agreements. Contingency provisions are considered to be the grant of an **option to terminate** a transaction by exercise of the right to cancel prior to the *expiration* of the option period.

Thus, the person authorized to cancel or otherwise benefit from the inclusion of the contingency provision, but does not need to use the provision to cancel the purchase agreement, need do nothing. He simply allows the "option period" for cancellation to expire.

The contingency is eliminated by the expiration of the right to cancel. Thus, a need never exists to approve or waive the contingency in order to do away with the right to cancel and proceed to close escrow, unless the purchase agreement wording states an approval or waiver is required to keep the contract alive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

Conditions not contingent

The condition of the property, namely the physical integrity of the land and improvements, is frequently not disclosed to the buyer before entering into a purchase agreement. Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and listing agents to hand the information to prospective buyers as soon as reasonably possible.

The listing agent has a mandated duty, owed to the public, to visually inspect the listed property and note his observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a Condition of Property or Transfer Disclosure Statement (TDS).

Not only is it **reasonably possible** for the listing agent to deliver the TDS before his seller enters into a purchase agreement with a buyer, it is mandated by case law and the economic imperatives of *transparency* to deliver property disclosures before a price is set in property transactions.

However, some stock purchase agreement forms convert the failure of the listing agent to deliver a TDS before the acceptance of an offer into a contingency, the result of a statutorily imposed penalty placed on the seller for his tardy disclosures. As the subject matter of a contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received.

If on review of the tardy disclosures the property conditions do not meet the expectations held by the buyer at the time he entered into the purchase agreement, the buyer may cancel the purchase agreement all due to the dilatory and misleading conduct of the listing agent, a type of fraud called *deceit*.

If not cancelled, the buyer would become the owner of property which is not in the condition and of the value he was *lead to believe* and to think existed when he entered into the purchase agreement.

Now applying the same disclosure of facts, consider a diametrically opposed purchase agreement provision written to handle the listing agent's dilatory in escrow delivery of the TDS without establishing a contingency containing the buyer's right to cancel.

Rather, the TDS provision calls for the buyer to review the seller's and listing agent's post-acceptance property disclosures. The provision grants no one the authority to cancel should the property's conditions be unacceptable or less than expected when entering into the purchase agreement. Instead, it requires **continued performance by all**.

Any significant discrepancies in the property's condition disclosed in the TDS and not observed or known to the buyer before entering into the purchase agreement allows the buyer **to notify** the seller of the defects and make a demand on the seller to cure them by repair, replacement or correction. If the buyer fails to give notice, he has let his right expire to demand the correction of previously undisclosed defects noted in the TDS and must proceed to close escrow. [See Form 269 accompanying Chapter 13]

However, if the buyer makes a demand on the seller to cure those defects first discovered by the buyer on his in-escrow review of the TDS, the seller is required to make the corrections before closing or suffer a reduction in the price equivalent to the cost to cure the noticed defects. Of course, the disclosure of the property's condition before the purchase agreement is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See **first tuesday** Form 150 §11.2]

The time set for delivery of data, information, documents and reports under a contingency provision so they can be approved or disapproved, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to *time-essence rules*. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Failure to close is a breach, unless excused

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent, which **must occur**, followed by a condition precedent (approval), which **may or may not occur**.

For example, a seller of a condominium unit is to first provide documents on the homeowners' association (HOA) to the buyer (the condition concurrent) for what then becomes the buyer's review (the condition precedent). Here, the seller **must deliver** the HOA documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller must obtain the documents or otherwise cause them to be handed to the buyer. If he does not, the seller has *breached* the contingency provision and the purchase agreement. [See Form 150 §11.9]

As for the buyer who receives the HOA documents, he must then enter upon a *good-faith review* of the document's content under his further-approval contingency provision. After the review and completion of any further inquiry or investigation into the HOA document's content, the buyer is to either express his approval by waiving or letting the right to cancel expire. However, if he has good reason and an honest belief that he cannot approve of their content, disapprove the documents by canceling the transaction.

Here, the seller is initially obligated to get the documents and deliver them to the buyer without concern for what steps the buyer may or may not be taking to perform any of his obligations under the purchase agreement, such as applying for a loan, providing a credit report or approving disclosures he has received.

Consider another **tandem-events provision** in which the buyer will execute a promissory note in favor of the seller in a carryback transaction. The buyer, in a *further-approval contingency provision*, agrees to prepare and hand the seller a credit application. On receipt, the seller is to review and then approve or cancel the transaction if the seller has a reasonable basis for disapproving the buyer's creditworthiness.

The buyer's obligation to deliver the credit application is a compulsory event he is required to perform. The failure to deliver the credit application is a *breach* of the further-approval provision since the buyer's delivery of the application is not conditioned on anyone (read the seller) first doing something. [See Form 150 §8.4]

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness. However, he is not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is *excused* from closing escrow by canceling the transaction. [See Form 150 §8.5]

Act to close without concern

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing his required obligations, such as obtaining a pest control clearance, an occupancy certificate, the release or reconveyance of liens on title, etc.

For example, a purchase agreement contains a contingency provision calling for the buyer to obtain and record a purchase-assist loan. Should the buyer fail to originate the loan as anticipated, the buyer may cancel the transaction and be *excused* from further performing.

However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as signing and returning the seller's escrow instructions, providing a deed or ordering out inspections and reports required to be obtained by the seller. [**Landis** v. **Blomquist** (1967) 257 CA2d 533]

A person's performance of an activity which **must occur**, versus his undertaking to bring about an event or approve a condition which **may or may not occur**, is an important distinction to be made. One is a *breach* of the purchase agreement should the activity not occur; the other *excuses* any further performance by cancellation should the described event not occur. Both failures permit the purchase agreement to be canceled by the opposing party, but a breach carries with it **litigation and liability exposure**.

For example, the buyer of a nonresidential income property is willing to purchase the property only if the seller cancels a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes he can negotiate a cancellation of the lease, the listing agent does not want his seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease. To accept the purchase agreement with the provision calling for delivery of the title clear of the lease would place the seller in breach if he could not negotiate a cancellation of the lease. Thus, the seller would be exposed to liability for the decrease in the value of the property resulting from the lease remaining as a defect (i.e., an unapproved encumbrance) on the title.

Here, the seller should submit a counteroffer prepared by the listing agent calling for the delivery of title to be contingent on the seller's termination of the lease, an **event-occurrence contingency provision**.

Thus, the seller will only become obligated to make a good-faith effort to negotiate the cancellation of the lease. Should he fail to be able to deliver title clear of the lease, he may cancel the transaction and be *excused* from any further performance, and, importantly, be free of any liability for the failure to deliver title as agreed.

Performing without concern

Many contingency provisions authorize the buyer to exercise his right to cancel at any time up to and including the date scheduled for closing should the identified condition or event fail to occur. In the interim, the seller must fully perform all of his obligations to deliver to escrow all documents needed from the seller to close. After the seller has fully performed, the buyer, at the time of closing, may then cancel on failure of the condition or event.

The **rights of a seller** in the buyer's contingency provision include assurances that:

- the buyer must act on any cancellation before the *right to cancel expires*; and
- the cancellation is the result of a good-faith effort by the buyer to act reasonably to *satisfy the contingency* so the transaction can close.

Consider a purchase agreement with terms for the payment of the purchase price which include having the buyer obtain a purchase-assist loan. The close of escrow is contingent on the buyer recording the loan since the buyer has the right to cancel if payment of the price cannot be funded by a purchase-assist loan. [See Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow, the receipt of which is needed to close escrow. The buyer then refuses to submit his loan application and fees

to his lender until the seller has fully performed all his obligations for escrow to close. The buyer claims it is futile for him to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached his duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver deeds, termite clearances, etc. to escrow are **independent obligations**, called *conditions concurrent*. Thus, the buyer and seller must each perform their part of the closing activities without concern for whether the other person has or is performing.

Also, the seller must, prior to the date scheduled for close of escrow, have fully performed all the acts required of the seller for escrow to close, and perform them in a timely manner for escrow to close on the date scheduled. The seller must comply even though the buyer's right to terminate the transaction can be exercised by canceling the escrow as late as the date scheduled for closing. [Landis, *supra*]

Sellers who agree to loan contingency provisions for buyers often require a separate and specific time-essence contingency provision to assure themselves that the buyer will act promptly to arrange a loan. In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer is qualified for a loan in the amount sought. [See Form 150 §4.1]

Now, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of his creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller may cancel the transaction.

Purchase agreement as binding

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement *void*, as though it were a mere illusory contract which never was binding.

On the contrary, when an offer is accepted, a *binding agreement* is formed. The overriding issue on forming a binding purchase agreement which contains a contingency provision is whether the purchase agreement will ever **become enforceable** by the elimination of contingencies as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of his corporation, employs a broker who locates a suitable building. It appears the property will be sold to another person before board approval can be obtained authorizing the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president, on behalf of the corporation, submits a signed purchase agreement offer to the listing agent agreeing to buy the real estate, conditioned on the **further approval** of the board of directors within 20 days of acceptance.

The seller accepts the offer after his listing agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus *eliminates* the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes his due diligence investigation.

Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Here, the seller has a binding commitment from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision. [**Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973]

However, the officers and board of directors of any corporate buyer or seller must act in *good faith* when exercising a contingency provision by cancellation. Accordingly, the officers need to submit the purchase agreement transaction to the board. The board then needs to review the purchase agreement. If conditions are unacceptable, the board should reject the purchase agreement in a resolution stating a reasonable basis for exercising the corporation's rights under the contingency provision to disapprove of the property selection or the terms of purchase and cancel the transaction. [**Jacobs** v. **Freeman** (1980) 104 CA3d 177]

Chapter 26 Cancellation excuses further performance

This chapter evaluates the conduct of a buyer or seller under a contingency provision in a purchase agreement which cancels their transaction and excuses any further performance of the agreement.

Exercising the option to terminate

Consider a seller who has agreed to carry back a note which is secured by a second trust deed junior to the existing trust deed note the buyer is to assume. The purchase agreement entered into with the buyer contains a **further-approval contingency provision** which grants the right to cancel the transaction to:

- the seller if the buyer's *creditworthiness* is unacceptable to the seller [See **first tuesday** Form 150 §8.5]; and
- both the buyer and the seller if either one disapproves of the existing trust deed lender's *terms for an assumption* of the loan by the buyer should the terms exceed the loan parameters agreed to in the purchase agreement. [See Form 150 §§8.6 and 10.3]

On the seller's receipt of the buyer's credit application form, the listing agent orders and receives a report on the buyer's creditworthiness from a credit reporting agency.

The seller, on review of the information with his agent, expresses concern about the buyer's payment history. The listing agent asks the buyer for more information regarding the buyer's income and net worth. Specifically, the agent asks for a **balance sheet** listing assets and liabilities and an end-of-year **financial statement** on the buyer's income and expenses for the past two calendar years.

The buyer promptly supplies the additional financial data. Meanwhile, the listing agent learns the buyer is going to use a line of credit at a bank to finance the down payment called for in the purchase agreement. As this information may affect the carryback seller's decision to exercise his right to cancel the transaction under the credit approval contingency, the listing agent relays the information to the seller.

With all the relevant credit information readily available and known to the listing agent now in the hands of the seller, the seller determines he has *justification* for exercising his option to terminate the purchase agreement transaction and cancel escrow. However, the seller has not yet decided what to do about allowing the transaction to continue.

Gather facts and timely respond

The listing agent is mindful of the upcoming expiration date of the seller's right to cancel and of his duty to protect the interests of the seller. Seeing his client's inaction, the agent advises the seller that if he does nothing to cancel by the expiration of his right he will have lost his ability to be *excused* from completing the transaction, whether or not the buyer's credit is acceptable.

The seller understands he must serve a notice of cancellation on the buyer before the expiration date set in the contingency provision, unless he intends to let the period for cancellation expire and proceed to close escrow.

On the expiration date of the seller's right to cancel, he decides to do nothing. The seller is willing to undertake the additional risks, including the possible need to foreclose, presented by the buyer's insufficient creditworthiness.

In the meantime, the lender has processed the buyer's application to assume the loan and forwarded assumption documents to escrow for the buyer to sign and return. The terms for an assumption demanded by the lender include a modification of the interest rate, a new amortization schedule for payments and a due date not previously included in the note. However, these terms exceed and are more financially burdensome than the loan assumption parameters agreed to in the purchase agreement.

The buyer promptly signs the loan documents and returns them to escrow, together with the assumption fee demanded by the lender. Thus, the buyer, by conduct inconsistent with his right to cancel granted him by the loan assumption contingency provision, has *waived* his right to cancel the transaction. The buyer now no longer has the authority to terminate the purchase agreement for failure of the terms for an assumption to fall within the parameters agreed to in the purchase agreement. [See Form 150 §10.3]

The seller on learning that the terms for assumption and modification of the existing first trust deed note determines they exceed the parameters of the loan assumption terms agreed to in the purchase agreement. He instructs his listing agent to prepare a notice of cancellation to terminate the transaction and escrow. The notice is immediately signed by the seller and delivered to the buyer and escrow.

Here, the risks of loss presented by the loan modification accompanying the assumption agreement is greater than the risks presented by the terms agreed to in the purchase agreement. Thus, the seller has a valid reason for refusing to subordinate to terms which would put his carryback note at a greater risk of loss of his security than agreed.

The seller's cancellation now allows the seller (as well as the buyer) to avoid any *further performance* of the purchase agreement or escrow since all obligations to close escrow have been *excused*.

An authorized unilateral cancellation

Cancellation of a real estate purchase agreement and escrow is due either to a *breach* of the agreement by the other party or the *failure* of an event to occur or a condition to be approved as called for in a contingency provision. The act of canceling is a *unilateral agreement* since the cancellation of the purchase agreement is undertaken by one person only. Cancellation **does away with** whatever remains to be performed under the purchase agreement, called *termination of the contract*.

Terminated is the right to buy or sell the property and close escrow by enforcing the further performance of the agreement. Thus, a cancellation affects the *future enforcement* of the agreement from the moment of cancellation. However, the cancellation of a purchase agreement does not affect the legal consequences and liabilities for activities and *events which preceded* the cancellation.

Conversely, *rescission* of either an unexecuted purchase agreement (i.e., escrow has not yet closed) or of a completed real estate transaction (i.e., escrow has closed) is a *bilateral agreement* in which both the buyer and seller, acting in concert, **retroactively annul** the purchase agreement from the moment it was entered into.

While a **cancellation** merely brings a purchase agreement to a standstill, a **rescission** returns the buyer and seller to their respective positions **prior to entering into** the purchase agreement, as though they had never agreed to the transaction. The retroactive return to their former, pre-contract positions is called *restoration*.

When both the buyer and seller enter into a rescission agreement, the **restoration** of the buyer and seller to their pre-contract positions eliminates all claims they may have had against each other for conduct which occurred after entering into the purchase agreement and prior to its rescission. A rescission is voluntarily accomplished as part of a mutual agreement to eliminate the purchase agreement, called a *release and waiver agreement*. [See **first tuesday** Form 181]

Distinguished from a cancellation of the purchase agreement is the unilateral or mutual cancellation of only the **escrow instructions**, without including any reference to cancellation of the purchase agreement. Often, due to a dispute or failure of a contingency, escrow will not close. Here, escrow will issue instructions calling for the return of funds and documents to the party who deposited them in escrow.

These cancellation-of-escrow instructions, signed by both the buyer and seller, need not also call for a cancellation of the purchase agreement. If the purchase agreement is **not also canceled**, the cancellation instructions handed escrow do not interfere with any rights the parties may have to enforce the purchase agreement. Escrow instructions are a separate contract from the purchase agreement.

The purchase agreement remains intact to be enforced to buy, sell or recover money losses. [Calif. Civil Code §1057.3(e)]

Cancellation for a valid reason

A seller or buyer who refuses to hand escrow the instruments (funds and documents) needed to close the transaction or otherwise comply with the escrow instructions has breached the agreement, unless his nonperformance is *excused*.

Nonperformance is **excused**, and the refusal to act is not a breach of the purchase agreement, if:

- a contingency *provision exists authorizing* the buyer or seller or the person benefitting from the contingency to terminate the purchase agreement on the failure of an event to occur or on disapproval of data, information, documents or reports;
- the *event fails* to occur or the condition reviewed is disapproved; and

Figure 1

*Excerpt from **first tuesday** Form 159 —*
Purchase Agreement — Income Property other than One-to-Four Residential Units

11. ACCEPTANCE AND PERFORMANCE:

11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

11.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

11.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ____.

11.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]

11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Form 171 or 172]

11.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $_______________.

- the person authorized or benefiting from the contingency provision *acts to terminate* the agreement by delivering a notice of cancellation prior to the expiration of his right to cancel. [See Form 183 accompanying this chapter]

When a **valid reason** exists which triggers the buyer's or seller's right to *exercise* their option to cancel, and they choose not to serve a notice of cancellation on the other party, their option to be *excused* from further enforcement **expires**.

Conduct less than disapproval

Consider a buyer who has entered into a purchase agreement and later receives a property operating cost sheet from the seller for his review and approval, called an *income and expense statement* or an *Annual Property Operating Data* (APOD) sheet. Receipt commences a **period of review** by the buyer to determine whether to exercise his right of disapproval and cancellation of the purchase agreement under a contingency provision. [See Figure 1 accompanying this chapter, *ante*]

The data tends to confirm the general information received by the buyer before making the offer. However, the breadth and depth of the information seems inadequate for a large, long-term investment. Thus, the seller is asked by the buyer's agent to supply additional data and information, including access to all supporting documentation regarding the property's operating history.

The seller claims the information he has already handed over sufficiently discloses the property's operating history and the buyer's request for more data and documents constitutes a disapproval of the information and acts as a cancellation. Thus, the seller says the deal is dead.

Has the buyer, by seeking additional information, disapproved of the condition of the income and expenses, and thus exercised his right to terminate the agreement?

No! The buyer's **request for additional data** on the property's operations is an expression of concern, not a disapproval. Implicit in a request for more information is the notion that a decision of any type has not yet been made.

Further, the seller has not fulfilled his obligation to deliver sufficient information to allow the buyer to complete his review and make an informed decision about the acceptability of the property's operations.

Before an agreement is terminated by a buyer exercising a contingency provision, the buyer's conduct must rise to the level of an *unequivocal disapproval* of the condition presented by the data, information, documents and reports supplied by the seller.

For a termination of the purchase agreement to occur, the buyer must either deliver a notice of cancellation, as called for to exercise the right granted to terminate the agreement, or otherwise communicate an *unequivocal rejection* of the disclosed condition to the seller.

Any inadequacy of information perceived by the buyer may result in the buyer's inquiry into the apparent failure or possible unacceptability of the conditions disclosed. A request for more information is to be complied with by the seller as his obligation under the contingency provision.

The seller who fails to comply with a reasonable request for more information made in good faith to assist the buyer in the decision making process of approval or disapproval of the condition under review has breached his obligation under the contingency provision to hand over data, information, documents and reports.

NOTICE OF CANCELLATION

Due to Contingency or Condition

DATE: _____________, 20______, at ____, California.

TO: ____

Items left blank or unchecked are not applicable.

FACTS:

This is a notice of cancellation and termination of the following contract:

☐ Purchase agreement

☐ Escrow instructions

☐ Exchange agreement

☐ Counteroffer

☐ ____

dated _____________, 20______, at ____, California,

entered into by you and the undersigned, regarding real estate referred to as ______________________________

____.

CANCELLATION AND TERMINATION:

The above referenced contract and any underlying agreements are hereby cancelled and terminated.
This cancellation is based on:

1. ____

____

2. ____

____

3. ____

____

4. And further, is cancelled for any other legally sufficient grounds not here mentioned.

5. If approved by all parties, the real estate broker(s) and escrow agent(s) are hereby instructed to return all instruments and funds to the parties depositing them.

I agree to this notice and instructions.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______, at __________________________, California.

Signature: ____

Signature: ____

RECEIPT AND CONSENT TO CANCELLATION

I acknowledge receipt of a signed copy of this notice and agree to this cancellation and instructions.

Date: _____________, 20______, at __________________________, California.

Signature: ____

Signature: ____

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Thus, the seller has **defaulted** on his obligations, a *breach* which excuses the buyer's further performance until the seller complies with the requests. Further, the seller's breach of the provision allows the buyer to either cancel the agreement or pursue enforcement by a *specific performance* suit.

Post-cancellation waiver attempt

Consider a prospective buyer of nonresidential property who includes a further-approval contingency in his purchase agreement offer calling for his approval of a survey to be furnished by the seller. The seller accepts the offer and a survey is conducted.

The surveyor's observations are delivered to the buyer as agreed in the contingency provision. On the buyer's review of the survey and accompanying report, the buyer discovers the location of structures does not conform to building permits. Thus, the buyer has a reasonable basis for exercising his right to cancel the transaction under the contingency provision.

However, the buyer's agent does not prepare a notice of cancellation form for the buyer to sign and deliver to the seller as required by the purchase agreement for a termination of the transaction. Instead, the buyer advises the seller of his disapproval of the survey in letter form. However, the buyer does not state he is canceling the transaction due to his disapproval.

The seller does not respond to the buyer's disapproval letter in an effort by the seller to work out the discrepancies found in the survey and resolve the differences by an approval of the survey or a waiver of the contingency.

Prior to the date originally scheduled for escrow to close, the buyer's agent prepares a notice of waiver of the further-approval contingency which the buyer signs. On the seller's receipt of the notice of waiver, the seller has escrow prepare unilateral cancellation instructions which the seller signs and hands escrow. The buyer then demands a conveyance of the property as agreed in the purchase agreement, which the seller rejects.

The seller claims the letter disapproving the survey *terminated* the transaction and *excused* the seller (and the buyer) from further performing on the purchase agreement or escrow.

The buyer believes his communication did not cancel the transaction, but merely disapproved of the survey without exercising the contingency provision which has now been waived and no longer affects the enforceability of the purchase agreement.

Here, the buyer **unequivocally disapproved** the conditions disclosed by the survey. As a result, his rejection of the survey by the disapproval was itself an *exercise* of the buyer's right under the contingency provision to terminate the purchase agreement and escrow. The disapproval is as effective as though he had signed a notice of cancellation and delivered it to the seller.

Thus, on disapproval of the survey, the buyer terminated the purchase agreement. The buyer is left without any contract, much less a right to cancel which he may later attempt to waive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

Chapter 27 Time to perform

This chapter looks into the enforceability of one person's right to cancel a transaction when the other person fails to perform by an appointed date.

Default and cancellation

The short, seemingly harmless *time-is-of-the-essence provision* stands alone amongst the boilerplate provisions of some, but not all, stock purchase agreement forms used to buy and sell real estate in California. By its plain words, the existence of a time-essence provision **gives notice** to the buyer and seller that their compliance by the date scheduled for an event to occur or a condition to be met as called for in the purchase agreement or escrow instructions is **essential to the continuation** of the transaction.

Thus, the bargain built into the purchase agreement by the presence of the **time-essence provision** gives the buyer or seller the right to **immediately cancel** the transaction on the failure of an event to occur or the other person to approve a condition by the appointed date.

By virtue of the multiple number of tasks a typical buyer undertakes to close a transaction, contrasted with the very few tasks imposed on a seller to close, the time-essence clause "stacks the odds" of losing a transaction against the buyer. This condition exists even though the buyer and all the third parties involved on their behalf may have acted with diligence at all times.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a **risk of cancellation** on a transaction which is not helpful. Foreseeable delays in closing a transaction exist in all real estate sales.

Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation that is typically initiated by the seller.

*Editor's note — **first tuesday** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month. [See **first tuesday** Form 150 §10.2]*

Purpose of the time-essence provision

The "common understanding" said to exist as the purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory for enforcing appointed dates as deadlines for the occurrence of events or the approval of the conditions called for in agreements containing a time-essence clause is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform.

However, delays in closing of a few days or even a few weeks or more, while inconvenient, rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel

due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere, i.e., "money is of the essence."

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of lost rental value (or carrying costs of the property) for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs and causes the seller an incalculable (and uncollectible) loss arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale (not his entry into the sale) to complete some other transaction.

As for the buyer, his losses on a seller's default usually arise out of a missed closing deadline which he needed to meet in order to receive tax benefits or a locked-in (low) interest rate loan.

Termination of rights

An effective **Notice of Cancellation** interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions.

On a proper cancellation, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See Form 183 accompanying Chapter 26]

For example, the person who **properly cancels** a purchase agreement has the unfettered right:

- in the case of a seller, **to retain ownership** or resell the property to other buyers at a higher price; and
- in the case of a buyer, *to keep his funds* or use them to purchase other property on a better bargain.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by canceling the purchase and escrow agreements. The alternative to canceling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so.

Should the "grace period" of additional time be granted, and then expire without compliance, a cancellation for failure to then perform is most understandable by all involved, and enforceable. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Still, an effective **cancellation** by one person *forfeits the rights* held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, the agents, escrow, lender and title company are all adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed.

For example, when a seller cancels, the buyer loses, by *forfeiture*, his contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership.

Thus, a cancellation by either the buyer or the seller, if proper and enforceable, is the "final moment" in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale who would have benefitted by the closing of the transaction.

Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.

Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be approved, the **purchase agreement** or escrow instructions should contain:

- a clear *description of the event* which is to occur or the condition to be approved;
- an appointed date or *expiration of a time* period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the *right to cancel* the transaction as the consequence of a failure of the event or the approval to occur by the appointed date.

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, then the seller will only be **allowed to cancel** if:

- the seller has performed all acts which must precede, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller cannot be in default);
- the event or approval *fails to occur* by the appointed date; and
- the seller *performs or stands ready*, willing and able to perform all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

The notice given by the existence of the time-essence provision advises the buyer that his performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of his failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be forfeited.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time-related provision** contained in the purchase agreement and escrow instructions. The different provisions which might be included are:

- a *time-essence provision*, which gives the seller the right to cancel should the event or approval of a condition called for not occur by an appointed date;
- a *seller-may-cancel contingency* provision, which authorizes the seller to cancel should the condition or event not occur, whether or not a time-essence clause exists;
- an *authorization-to-extend* provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a seller-may-cancel clause exists [See Form 150 §10.2]; and
- an *extension of time granted* by the seller, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension should the event or approval not be forthcoming.

Elements of a default

Before either a buyer or seller can effectively cancel a transaction, they must "place the other person in default." Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts must exist:

- a date crucial to the continuation of the transaction must have passed;
- the condition called for in the purchase agreement did not occur by the scheduled date; and
- the person canceling must have fully performed all activities required of him in order for the other person to perform by the scheduled date, called *conditions precedent*, and have performed or be ready, willing and able to perform, at the time of cancellation, all activities he was obligated to perform in order to close escrow, called *conditions concurrent*.

Was the cancellation timely

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow instructions must clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day will subject his contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents must consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not so worded, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrows are nearly always instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Thus, in this example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement." Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as loan commitments, termite reports, funds for closing or clearance of encumbrances from title is merely a "target date" preliminary to establishing the right to cancel.

Time to close extended by notice

To establish the **right to cancel** when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default must be *given notice* that the date set as the "new deadline" will be strictly adhered to.

Further, the person in default must be given a realistic opportunity (period of time) after being given a notice to perform before any cancellation would be effective. Continued nonperformance past the new deadline date will be treated as a **default** and escrow can be immediately canceled. [See Form 181-1 accompanying this chapter]

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions (other than the *implied right* to cancel exercisable on a

NOTICE TO PERFORM AND INTENT TO CANCEL

NOTE: This form is used by a party to a transaction who has performed to advise another party who has not performed as agreed to perform by a specified date or expect the transaction to be cancelled.

DATE: _____________, 20______, at ____, California.

1. This notice regards the performance of a Purchase Agreement

1.1 entered into between ____, as the Seller, and ____, as the Buyer,

1.2 dated __________, 20______, at ____, California,

1.3 regarding real estate referred to as ____, and

1.4 escrowed with ____, escrow number ______________________________, under instructions dated _____________, 20______.

NOTICE TO PERFORM:

2. Demand is hereby made on you under the above referenced agreement and escrow instructions to perform

2.1 on or before _____________, 20______,

2.2 as follows: ____

____

____

____

____

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____

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____

____.

3. It is the intent of the undersigned to cancel this transaction should the performance demanded of you in this notice not occur during the time period given.

I agree to this notice.

Date: _________________, 20_______

By: ____

Signature: ____

By: ____

Signature: ____

FORM 181-1 04-08

failure of the other person to perform) or agent authorization to extend performance dates exists. [See Form 150 §12.2]

The seller agrees with the buyer's request to extend the date of performance (closing) an additional 30 days during which the buyer is to complete his arrangements to close escrow. Two days after the extension expires, the seller cancels the transaction.

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller *exercised* his right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective. [Fowler, *supra*]

Now, consider an example of strict compliance with performance dates as "deadlines," after which the purchase agreement and escrow can be terminated by cancellation for failure of the described activity or event to take place. The **purchase agreement** contains a simple time- essence clause. Authority is not granted to the agents to extend performance dates should the appointed date for performance prove to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, **escrow instructions** provide for an interference with closing of the escrow after the date initially targeted for closing. The instructions authorized escrow to close at anytime after expiration of the escrow period, unless escrow received instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant him the additional time needed to close escrow before the buyer can *forfeit the seller's right* to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time he needs to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement.

More importantly, **escrow was authorized** to return the money and instruments on the demand of either the buyer or seller should the closing not occur on or before the date set for closing. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction. [**Ward** v. **Downey** (1950) 95 CA2d 680]

Intent in conflict with time-essence clause

Consider a sale under a purchase agreement (or escrow instructions) which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month."

The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement."

Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record his purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

Can the seller cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction could be canceled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions express a contrary intent**.

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

Here, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow could hardly be considered crucial to the continued viability of the transaction. Accordingly, the seller must give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed for the agent to record the buyer's loan, before the buyer's failure to perform justified exercising any cancellation rights. [See Form 181-1]

Editor's note — The fact the agents do not exercise the authority granted them to extend the time for performance is of no concern. It is the mere existence of the agents' unrestricted right to extend performance dates by up to 30 days which requires the person canceling to allow the other person a reasonable, additional time period in which to perform before cancellation can occur.

Default needed to justify cancellation

Before a buyer or seller may consider canceling a transaction, the other person must have *defaulted* on his completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See Form 150 §10.2]

Thirty-three days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most importantly for the buyer and agents, time for closing was not made crucial to the continuation of the agreement.

Thus, a reasonable period of time must pass before the buyer is in default. Only when the buyer is in default may the seller *exercise* his right to cancel. [**Henry** v. **Sharma** (1984) 154 CA3d 665]

Now, consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

The buyer fails to sign and return escrow instructions to open escrow.

The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for his failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction. A reasonable period for the buyer to open escrow ended well before the scheduled closing date.

The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost his right to buy the property since he did not cure the default by opening escrow before the date set for closing and the seller's cancellation. [**Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a (remorseful) seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

To cancel you must first perform

Consider a seller who wants to cancel a transaction since the **buyer is in default** under the purchase agreement or escrow instructions. Before the seller may cancel, **the seller must**:

- *perform all acts* and cause all events to occur which, by agreement or necessity, are the seller's obligation and must occur before the buyer becomes obligated to perform or can perform, called *conditions precedent*, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval;
- *fully perform all activities* and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called *conditions concurrent*, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close; and
- *perform or demonstrate* he can perform all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called

conditions subsequent, such as meeting any requirements of the buyer's lender for repairs or clearances.

Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

When failure to fund is not a default

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed his obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller must have already fully performed by providing documents (deeds, releases, reconveyances, title clearances, etc.) so the conveyance of title can be insured and property clearances, prorates and adjustments can be delivered and accounted for as called for in the escrow instructions. If the seller has not delivered instruments so escrow can be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer (or lender) for funds. The deposit of closing funds would be premature since escrow cannot yet close.

Further, when the closing is contingent on the buyer recording a purchase-assist loan, escrow, as a matter of *commercial necessity*, does not call for the buyer's funds until the lender is ready to fund.

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests the buyer's funds, which the buyer **then fails to deliver**. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, called a *condition precedent* to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is *excused*. The seller has failed to hand escrow documents and information sufficiently in advance of the scheduled closing date for escrow to close by the appointed date. [See Form 150 §12.2]

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title, such as abstracts, trust deeds, leases, tax liens, assessments, etc., which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for his deed, the buyer is not in default for not yet depositing his funds.

Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, thus allowing one person to immediately cancel on the other's default, **inconsistent conduct** by the person entitled to cancel constitutes a *waiver* of his right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow (or the buyer) clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits his closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since he failed to deposit his funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller *waived his right* to cancel, time having been of the essence, by conducting himself without concern for the passing of the appointed date for closing. The seller failed to deliver up documents or information sufficiently in advance for escrow to meet the deadline. [**Katemis** v. **Westerlind** (1953) 120 CA2d 537]

However, a **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct must occur** by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time must be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time must have passed after waiver of the right to cancel, before the transaction can be canceled.

Time is best reinstated as essential to the continuation of the transaction by notifying the person who needs to perform that he must perform by the end of an additional period of time, set with sufficient duration as is needed to provide him with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly canceled since *strict compliance* with the extension is now enforceable.

Chapter 28 — The seller's breach

This chapter illustrates the conduct of a seller which constitutes a breach of the purchase agreement and imposes liability on the seller for any increase in property value, the buyer's expenses and interest on the amounts recovered.

Failure to act or act timely

On occasion, a buyer's agent in a real estate sales transaction will be confronted with conduct by the seller which interferes with the close of escrow. The seller's conduct is inconsistent with or contrary to those activities the seller is required to perform before escrow can close.

Examples of **seller interference** with a buyer's acquisition of property include the seller's failure to (timely):

- return escrow instructions;
- deliver closing documents;
- provide escrow with information on the existing lenders so payoff demands, beneficiary statements or assumption papers can be ordered on existing loans;
- deliver seller identification information for title insurance purposes;
- eliminate agreed-to defects and previously undisclosed property defects known to the seller and unacceptable to the buyer;
- arrange or permit inspection of the property by the buyer, appraiser, home inspector, city inspector, etc.; or
- close escrow.

Thus, the seller is not fulfilling the objectives of the purchase agreement he entered into with the buyer to **voluntarily perform** under the escrow instructions. As a result, the buyer is either unable to proceed toward closing or has fully performed (or his further performance is excused due to a cancellation by the buyer), and escrow cannot close due to a failure on the part of the seller to act.

Typically, the seller's refusal or failure to timely act under the purchase agreement and close escrow arises during dramatic increases in the value of the type of property he has just agreed to sell to the buyer. Thus, a better bargain can be had by the seller with other buyers since the seller has either agreed to a below market price or the market value was or has risen dramatically above the price agreed to in the purchase agreement.

As a result, "seller remorse" has set in, manifested by his efforts to trigger a default by the buyer which will justify terminating the purchase agreement.

Faced with the failure of escrow to close, due to the seller's *nonperformance or obstruction* of the buyer's efforts to close escrow and the inability of the buyer and agents to induce the seller to **voluntarily close escrow**, the buyer must make a pivotal decision regarding his bargained-for ownership of the property.

The decisions available to the buyer, called *remedies*, when the seller breaches the purchase agreement or escrow instructions include:

- **abandoning the transaction** by entering into a mutual cancellation of the purchase agreement and escrow instructions with the seller, agreeing to do nothing further to enforce the right to purchase the property or seek a money recovery from the seller, other than a return of the buyer's good-faith deposit;
- **acquiring the property** by pursuing enforcement of the purchase agreement and escrow instructions;
- **pursuing the recovery of money** when the buyer **wants to acquire** the property but cannot now do so due to the seller's conveyance of the property for a measurably higher price to another person who was unaware of the pre-existing purchase rights held by the buyer; and
- **pursuing the recovery of money** when the buyer can, but **no longer wants to acquire** the property, and the value of the property was measurably higher on the date the seller canceled escrow than the price the buyer agreed to pay.

An unsuspecting buyer who acquires the ownership of real estate without actual knowledge or recorded notice (constructive knowledge) of a pre-existing enforceable purchase agreement held by another buyer regarding the same property is referred to as a *bona fide purchaser* (BFP). As a BFP, the buyer pays consideration for the acquisition of property and takes title without knowledge of a claim to the property held by the other buyer. [Calif. Civil Code §3395]

Economic motives in a rising market

Market conditions surrounding a seller's refusal to voluntarily cooperate with a buyer and transfer property under a purchase agreement usually consist of:

- seller pricing power (due to too little inventory for too many prospective buyers);
- cyclically moderate to low mortgage interest rates; and
- a generally recognized trend in price increases, commonly referred to as a "hot (seller's) real estate market."

It is during these economic "boom" or "bubble" periods of fast upward movement in real estate prices that sellers often agree to sell property before checking out their property's value.

The failure to ascertain the value of the property before the seller enters into a purchase agreement sometimes results in his later discovery (prior to closing) that the sales price agreed to is significantly below the present worth of the property. It is then that the seller determines additional money can be had by simply canceling what is now viewed as a "bad bargain" and reselling the property to another buyer at a higher price.

The end game for all sellers of real estate is to net the most money possible on a sale under current market conditions. However, when a seller decides to cancel a sale so he can position himself to resell the property at the higher market value, he merely encourages the buyer to pursue the same end game for himself, i.e., the recovery of money from the seller equal to the increase in price received on a resale by the seller.

Thus, if the seller is pursued by the buyer for the difference in price, the seller will be unable to retain the financial advantage he sought to attain by breaching and reselling at a higher price.

Misplaced reliance on an adverse party

Consider an owner of nonresidential real estate who lives out of the area. The absentee owner is solicited by a buyer's agent seeking to locate properties suitable for his buyer. The owner responds indicating he

will sell the property, but does not know its value. He requests an indication of its value from the buyer's agent.

The owner is a sophisticated and intelligent individual capable of understanding that the buyer and the buyer's agent are his adversaries in negotiations.

After phone calls and correspondence exchanging information about the property, the buyer's agent states he does not want to express an opinion of value on someone else's property, but has shown his buyer **similar properties** offered at $200,000. The owner does not indicate what he believes the value of his property might be, but acknowledges he knows the market value of nonresidential property is on the rise.

The buyer's agent prepares a purchase agreement offer for a cash price of $250,000. The buyer signs the offer and it is faxed to the owner.

The owner accepts the offer and the buyer's agent promptly dictates escrow instructions, which the buyer signs and returns. The buyer, on receiving and reviewing the preliminary title report, advises escrow he will place the balance of the cash price into escrow when escrow calls for funds. The owner does not return escrow instructions or the deed for conveyance of the property.

The owner then visits the community where his property is located. For the first time, the owner inquires into the worth of his property by contacting some local agents. On his initial superficial inquiry, the owner finds that the property is worth considerably more than the price he has agreed to receive.

The owner quickly determines he has entered into an extremely bad bargain concerning the price the buyer has agreed to pay. Another buyer is located and a price of $750,000 is agreed to. Escrow is opened with the new buyer and closed immediately.

Meanwhile, the original buyer is involved in a futile attempt to close his escrow with the owner. When asked by escrow to sign and return the escrow instructions and the deed, the owner claims the agreement he entered into with the buyer was never a binding contract due to the buyer's **misrepresentation of the property's value** and the owner's reliance on the valuation to set the sales price. Thus, he explains, they have no deal.

The original buyer decides he no longer wants the property (or will not pursue acquiring it since the new buyer is a BFP).

Aware he has lost his ability to buy the property under the purchase agreement, the original buyer makes a demand on the owner for $500,000, the difference between the price agreed to and its worth on the owner's breach based on the price the seller received on the resale of the property.

The owner refuses to pay the demand claiming his refusal to close escrow at the agreed price was *justified* since the property's value was known to the buyer and the buyer's agent, but not to the owner. Thus, he claims, they took advantage of his ignorance of the property's true value, called *misrepresentation*.

Here, the owner owes the buyer the difference between the price agreed to with the buyer and the value of the property on the date the seller breached ($500,000).

Misrepresentation and deceit

Ordinarily, misrepresentation of a property's value by a prospective buyer and his agent does not, by itself, justify an owner's cancellation of the purchase agreement. Estimates of value made by prospec-

tive buyers and their agent's are usually mere expressions of their opinion, not facts to be relied upon by sellers since the buyer and the buyer's agent are **known adversaries** of any seller.

More importantly, the owner in the above example was neither induced or persuaded by the buyer or the buyer's agent to forego an independent investigation into his property's value, nor was the owner in a situation where he could not reasonably undertake an investigation into value.

For a representation of value by the buyer or his agent to be deceitful, the representation made to the owner must be coupled with *some other misfeasance*, bad action or false representation. Further, the owner was neither *gullible or ignorant*, nor unable to protect and care for himself as against the buyer or agent who he claims took unconscionable advantage of his ignorance of the property's value. Thus, his reliance on their expressions of value to set an acceptable price did not justify his cancellation.

The owner should have taken the opportunity, as he later did, to retain a broker (and pay him a fee) to determine the value of the property before agreeing to accept a price. [**Kahn** v. **Lischner** (1954) 128 CA2d 480]

Recover money, not the property

A buyer who seeks to recover money from a breaching seller, in lieu of title to the property, does so based on **monetary claims** which must fall within three categories of money losses:

- *general damages*, being money **directly expended** in the transaction;
- *consequential or special damages*, being money **collaterally lost** due to the seller's breach; and
- *prejudgment interest* on all monies recovered. [CC §3306]

General damages are monetary losses incurred by the buyer due to his expenditures and loss of value (price increase) that were **directly related** to his acquisition of the property, which he will not now acquire, including:

- **money advanced** by the buyer toward the price of the property, such as deposits held by the agent or escrow, or previously released to the seller;
- **expenses incurred** examining title conditions, inspecting the property, verifying operating income and expenses, and obtaining financing, escrow services, engineering and improvement plans, etc., all called *transactional expenses*;
- **move-in expenses incurred** preparing the property to take possession; and
- the **price-to-value difference** between the price agreed to in the breached purchase agreement and the value of the property on the date of the seller's breach.

Value-over-price on date of breach

Consider a buyer of real estate who enters into a purchase agreement to acquire one of two adjacent lots held by the owner. The purchase agreement contains a provision granting the buyer a *right of first refusal* to acquire the adjacent lot, also called a *preemptive right to buy*.

The right-of-first-refusal provision sets the price of the adjacent lot at $400,000, but does not state an expiration date for the right to buy it. Thus, the buyer believes he has the right to buy the adjacent lot should the owner decide to sell it at anytime during the owner's lifetime. A further, more formal, memorialization of the right of first refusal is not entered into. No memorandum of the right is recorded. The transaction closes.

Many years later, the owner conveys the adjacent lot to another person for $880,000. The person who acquires the adjacent lot has no knowledge of the outstanding right of first refusal which was triggered by his purchase. Thus, the buyer holding the right of first refusal is unable to exercise his preemptive right and acquire ownership of the adjacent lot. The person who acquired the adjacent lot is a *bona fide purchaser* (BFP), barring any recovery of the lot by the buyer.

The buyer claims the owner has breached the right-of-first-refusal provision in their purchase agreement. Thus, the buyer makes a demand for the monetary value of the lost right to buy since he no longer has the ability to acquire the adjacent lot.

The buyer's demand on the owner is for the sum of $480,000. The money demand is based on the difference between the price set in the right of first refusal provision and the *value of the property* on the **date of the breach**, plus interest at 10% (the legal rate) on the demand from the date of the breach until the demand is paid.

The owner refuses to pay the demand claiming the right of first refusal he granted at the time of the purchase of the first lot *expired* prior to the owner's sale of the lot since the provision did not contain an expiration date and a reasonable period of time for the right to continue in existence has long ago passed.

Can the buyer recover money equal to the **price-to-value difference** several years later at the time of the sale of the lot covered by the right of first refusal?

Yes! The right of first refusal which the owner granted did not express a date of expiration. Thus, the date of expiration becomes the date of the death of the owner who granted the right.

More importantly, the right to buy held by the buyer had not previously been triggered. Thus, the right could not have been exercised by the buyer until the owner triggered the right to buy by deciding to sell the property. It is the owner's decision to sell that provides the buyer, on notice of the decision (which he did not get), with his first *opportunity to exercise* the right by deciding to buy the property at the price and on the terms stated in the provision granting him the preemptive right to buy.

It is the length of the period **following the notice** of the owner's intent to sell which controls the buyer's actions. Delivery of the notice sets the period during which the buyer may *exercise* his right to buy. If this **period for exercise** is not stated in the right-of-first-refusal provision, it is limited to a *reasonable period* of time which begins to run when the buyer receives notice from the owner of his decision to sell.

Thus, it is the period **after the notice** which expires, not the grant of the right to buy, unless the right-of-first-refusal provision limits the term of the grant.

Accordingly, the buyer's **money recovery** of the value-over-price is the difference between:

- the *value of the property* on the date of the breach, here set by the price the owner received for the property on the resale (the event which triggered the right to buy); less
- the *price agreed* to in the right of first refusal provision as the amount the buyer was to pay for the property on exercise of the right to buy. [**Mercer** v. **Lemmens** (1964) 230 CA2d 167]

Preparing to take possession

Consider a buyer who enters into a purchase agreement with a builder to construct a new home. The buyer purchases appliances and upgrades the fixtures, which the builder installs.

Later, the builder substantially alters the construction plans for the exterior without the buyer's approval. The buyer demands the builder complete construction under the plans and specifications as agreed. The builder refuses since he has prospective buyers for the property at a significantly higher price.

The buyer decides he no longer wants the new home due to his conflict with the builder. He unilaterally cancels the purchase agreement since the builder has breached the agreement. The buyer now seeks to recover money from the builder, not the property.

Here, the actual **money losses** the buyer may recover from the builder include:

- funds advanced toward the purchase price, including good-faith deposits and monies released to the seller;
- the value-over-price difference between the price the buyer agreed to pay in the purchase agreement and the resale value of the property at the time of the builder's breach;
- expenses incurred to prepare the property for possession (to the extent they exceed the value-over-price difference), i.e., the expenditures made by the buyer for the additional appliances and upgraded fixtures; and
- interest from the date of the breach on all amounts of money recovered.

A buyer is allowed to recover expenditures incurred to prepare a property so he can take possession. The buyer and seller must intend for the expenditures to be incurred by the buyer as a condition in their purchase agreement. Recovery of construction costs advanced by a buyer for upgrades and additions gives the buyer the *benefit of the bargain* contemplated by both the buyer and seller when they entered into their agreement. However, the buyer cannot enjoy a double recovery for the upgrades he paid for when the price-to-value increase exceeds the cost of the upgrades.

Excluded from recovery are any expenditures by the buyer to purchase furnishings for the new home. The recovery of these expenses are typically not agreed to under a purchase agreement and are not related to the acquisition of real estate. Also, a seller cannot reasonably foresee these **collateral expenses** for home furnishings as becoming his obligation should he breach the purchase agreement.

Consequential damages, naturally

A buyer whose seller has breached their purchase agreement is also entitled to **recover expenses** incurred by the buyer *after the breach*, if the expenditures are the *natural result* of the seller's breach, called *consequential damages*.

For the buyer to recover post-breach expenditures, the seller on entry into the agreement must have known or should have known the expenses would be incurred by the buyer as a **natural and unavoidable result** of the seller's breach of the purchase agreement.

For example, consider a buyer who enters into an agreement to purchase a lot from a builder. The builder also agrees to complete the construction of improvements on the lot and convey the property by an agreed-to date.

Before the builder enters into the purchase agreement agreeing to sell the property and construct improvements, the builder is informed of the adverse tax consequences the buyer will be subjected to if the construction is not completed and the property conveyed by the date scheduled for closing. Thus, **time for performance** by completion of construction and close of escrow is known by the builder on entering into the agreement to be a prerequisite to the buyer's avoidance of profit taxes.

The buyer has sold real estate he used in his trade or business and needs to acquire ownership of a replacement property within 180 days after the sale closed. The time constraint must be met to qualify the sale as an IRC §1031 exempt transaction and avoid reporting profits and incurring state and federal tax liability for the tax on the profits.

However, the builder fails to complete construction and convey the property prior to the date set for closing. Thus, due to the builder's breach, the buyer is unable to avoid payment of the profit tax on the sale of his trade or business property. Also, the buyer is forced to rent another property (and incur moving expenses) until the construction the builder promised is completed.

Here, the **consequential damages** recoverable by the buyer in the form of a *money award* include:

- the full amount of the profit tax the buyer paid;
- the rent paid for the temporary facilities until the improvements were completed (plus the cost of additional moving expenses); and
- interest at 10% from the date the amounts of rent and profit tax were paid by the buyer. [**Walker** v. **Signal Companies, Inc.** (1978) 84 CA3d 982]

Interest due from date of loss

A buyer who recovers money losses is also entitled to recover **interest** at the **(legal) rate of 10%**, commencing on the date of the seller's breach, on amounts recovered for:

- the value-over-price money differential recovered;
- money paid toward the purchase price, whether held by the seller or as a deposit in escrow, until the date released to the buyer;
- funds expended on title examination and other transaction expenses incurred preparing to take title;
- expenses incurred preparing the property to take possession; and
- *consequential losses,* but only accruing from the date of their disbursement. [**Al-Husry** v. **Nilsen Farms Mini-Market, Inc.** (1994) 25 CA4th 641]

Consider a buyer who enters into a purchase agreement on a one-to-four unit residential property with a seller. The buyer opens escrow and deposits funds in accordance with the purchase agreement.

Meanwhile, the seller has received a better offer from another buyer. The seller, without telling the his original buyer, conveys the property to the second buyer.

The first buyer, whose purchase agreement has now been breached by the seller's conveyance to the second buyer, is **entitled to recover**:

- the increased value of the property on the date of the breach over his purchase price, with **interest on the difference** at the legal rate (10%) from the date of the breach; and
- the refund of his deposits held either in escrow or by the seller, plus **interest on the deposits** from the date of the breach to the date the deposits are returned to the buyer. [**Rasmussen** v. **Moe** (1956) 138 CA2d 499]

Nonrecoverable losses

A buyer's expenses and losses which are unrelated to the real estate and not intended to be incurred by the buyer based on the buyer's entry into the purchase agreement are not the responsibility of the breaching seller. Losses and expenses **too remote and speculative** to be foreseen by the seller when entering into the purchase agreement as his obligations should he breach are **not recoverable** from the seller.

For example, a buyer enters into a purchase agreement to acquire an unimproved parcel of commercial property. The seller knows the buyer plans to develop the property. Before escrow closes, the seller determines he can get a higher price for the property from other prospective buyers and cancels escrow.

Here, the buyer can recover any increase in the value of the land on the date of breach over the agreed-to purchase price, as may be reflected by the seller's resale of the property.

However, the buyer is **not entitled** to recover the **profits** he would have earned had he been able to acquire and develop the land. Lost profits for the **anticipated use** of the property to be purchased are unrelated to the sale and too speculative to be recoverable by the buyer. [**Stewart Development Co.** v. **Superior Court for County of Orange** (1980) 108 CA3d 266]

Also, lost income from rents a buyer would have received had he acquired property subject to a long-term lease are not recoverable. The recovery of rents is barred on a different legal theory from consequential losses since rents are related to the property.

Rent produced by income property is a factor used to establish the property's **present value**. To allow the buyer to collect *future rents* from a breaching seller when the buyer does not buy the property and the buyer is awarded a money recovery for the *increase in the resale value* (which by definition is established by the future flow of rents) would be double recovery, i.e., present value of the future flow of rent, plus those future rents. Thus, the buyer would be improperly placed in a **better position** than had the seller performed by conveying the property.

Further, interest serves the same economic function as rents. Both are a *return on capital*. Thus, when a buyer receives interest on the amount of his recovery, the further receipt of future rent would also be an **impermissible double recovery**. [**Stevens Group Fund IV** v. **Sobrato Development Co.** (1992) 1 CA4th 886]

Commercial reality of a call for funds

Consider a buyer and seller who enter into a purchase agreement which sets the date scheduled for the close of escrow. However, the purchase agreement does not contain a performance date by which the seller is to deliver documents to escrow. Escrow is opened.

The buyer obtains a commitment letter from a lender for a purchase-assist loan. The lender issuing the commitment informs escrow it will prepare loan documents and fund escrow within five days after its receipt of an estimated closing statement from escrow.

On the day scheduled for closing, escrow is still not in a position to prepare an estimated closing statement or call for closing funds from the lender or the buyer. The seller has not yet submitted a current rent roll statement needed by escrow to prepare the estimated closing statement.

Later that day, the seller submits a current rent roll statement to escrow, completing his performance of all conditions imposed on the seller by the date set for closing. On learning that the buyer has not yet deposited his funds into escrow, the seller hands escrow a written notice of cancellation.

The buyer makes a demand on the seller to convey title as soon as the lender is in a position to fund the loan. The buyer claims his failure to fund escrow by the closing date is excused due to the seller's **untimely delivery** of the rent roll statement to escrow.

Here, the buyer's failure to fund escrow when he had otherwise fully performed was *excused* by the seller's dilatory delivery of closing document to escrow. The seller must now allow escrow to close.

Escrow is a process which depends on the orderly receipt of documents to close the transaction, a process the seller must honor. Thus, as a matter of *commercial reality*, escrow will not call for closing funds from either the buyer or the lender until escrow is in a position to close. In turn, neither the buyer nor the lender will deposit or wire funds until they receive a call from escrow for funds.

Since escrow was not in a position to call for funds due to the seller's untimely performance, the buyer's delivery of funds by the date scheduled for closing was excused and the seller must allow escrow to close. [**Ninety Nine Investments, Ltd.** v. **Overseas Courier Service (Singapore) Private, Ltd.** (2003) 113 CA4th 1118]

The seller's obligation to deliver documents and the buyer's obligation to fund escrow are considered mutually exclusive *concurrent conditions*. Thus, they must be independently performed by the buyer and seller on or before the date scheduled for closing. However, in actual practice, escrows require receipt of all documents needed by escrow to close before they will **call for funds**.

Even with all the buyer's and seller's documents in hand, lenders generally need five to seven days to prepare, forward and receive signed loan documents before they will fund.

A provision might not exist in a purchase agreement calling for the seller to deliver documents to escrow prior to the date set for closing. However, the existence in all real estate contracts of an *implied covenant of good faith and fair dealing* imposes a duty on the seller to timely perform by taking action to avoid frustrating the buyer's right to receive the benefits of the contract, i.e., allow time for the buyer and his lender to fund escrow and for the buyer to receive title to the property. [See **first tuesday** Form 150 §12.2]

Chapter 29 — The breaching buyer's liabilities

This chapter digests a buyer's liabilities to a seller arising out of the buyer's breach of a purchase agreement for property value decreases, operating and carrying costs, and losses on a resale.

First, there must be a monetary loss

Consider a prospective buyer of a residence who is informed the seller has already entered into a purchase agreement to acquire a replacement residence. The seller is relying on the sale of his current residence to fund his purchase of the replacement residence.

The prospective buyer makes a written offer agreeing to pay cash for the seller's equity and assume the existing trust deed loan, called a *cash-to-loan transaction*. The seller accepts the offer. Escrow instructions are prepared and signed, and the buyer's good-faith deposit is placed in escrow.

Later, as agreed, the buyer deposits additional funds in escrow. Although escrow is not yet ready to close, the buyer agrees to release some of the downpayment money held in escrow so the seller can close his purchase of the replacement residence. The funds are released and the seller acquires his new residence.

The seller vacates the old residence he has *sold* and moves his family and belongings into the new residence.

To consent to the buyer's application to assume the seller's existing loan, the lender demands a modification of the interest rate and payment schedule, and an assumption fee. The buyer refuses to proceed with the loan assumption and cancels escrow.

The buyer makes a demand on the seller to return all funds the buyer deposited into escrow, which the seller rejects.

The seller then makes a demand to be paid the funds remaining in escrow. The seller claims the buyer has *forfeited* all funds since he breached the purchase agreement by not assuming the loan.

The seller promptly relists the property and it is **resold** for the same price, but on terms calling for payoff of the existing loan, requiring the seller to pay a prepayment penalty. The seller also agrees to pay the new buyer's nonrecurring closing costs and one point on new financing to be obtained by the new buyer. On closing the resale transaction, the seller's **net proceeds are less** than he would have received on the sale to the original buyer under the breached purchase agreement.

Can the seller recover any money from the original buyer by either:

- retaining all the funds deposited by the buyer; or
- accounting for offsets against the buyer's deposits for the seller's losses?

Here, the seller is entitled to recover his losses. However, he must **account for his actual money losses** caused by the buyer's breach since a *forfeiture of deposits* is not allowed, no matter the wording or initialing of forfeiture provisions.

Depending on the amount of the seller's **total recoverable losses** on the resale, the buyer's deposit will be partially or totally offset by the amount of the seller's losses caused by the breaching buyer. [**Allen** v. **Enomoto** (1964) 228 CA2d 798]

Recoverable seller losses

A seller's **total recoverable losses**, summarized here and analyzed in detail in this chapter, include:

- the *operating and carrying costs* of trust deed interest payments, taxes, insurance, maintenance and utilities, which were incurred by the seller during the period between the date of the breach and the date escrow closed on the resale;
- the *increased closing costs* due to the seller's payment of the new buyer's nonrecurring closing costs and financing fees on the resale which reduced the seller's net proceeds compared to the net proceeds the seller would have received from the breaching buyer;
- the *additional resale costs* of the prepayment penalty demanded by the lender on the loan pay-off; and
- *interest* on the seller's net equity from the date escrow was to close to the date of closing on the resale.

Resell or retain the property

A seller of real estate who is faced with a **breaching buyer** and the failure of the sales transaction must first decide whether to:

- *enforce* the purchase agreement and have a court order the buyer to close escrow, called *specific performance*;
- *remarket* the property for sale promptly and diligently seek to locate a buyer; or
- *retain the property* and postpone or entirely forego any resale effort.

Editor's note — This chapter illustrates money losses recoverable by the seller who chooses either to retain the property or resell it. Thus, the specific performance remedy is not considered here.

Only a money loss is recoverable

A buyer, due to his breach of the purchase agreement, owes the seller **actual money losses**, called *damages*, which are classified as:

- **general damages**, also called *normal damages*, being the dollar amount of any decline in the property's fair market value as of the date of the buyer's breach below the price agreed to in the purchase agreement;
- **special damages**, also called *consequential damages*, being:
  1. transactional costs incurred by the seller while preparing to close under the breached purchase agreement;
  2. marketing expenses, increased closing costs, and ownership and operating costs incurred to remarket and sell the property; and
  3. any further drop in property value after the buyer's breach for so long as the buyer interferes and stalls the seller's resale effort; and
- **interest** from the date of the buyer's breach to the closing date of a resale of the property on all money and any carryback note the seller was to receive [Calif. Civil Code §3307]; less
- **offsets or credits** due the buyer for

1. any rent received from tenants or the *implicit rent* for the owner's use of the property;
2. the amount of any price increase on the resale; and
3. the amount of any reduction in the seller's expenses on the resale, so the seller will not be placed in a better financial position than he would have been in had the breaching buyer fully performed. [**Smith** v. **Mady** (1983) 146 CA3d 129]

Price-to-value as a money loss

When a seller decides to resell the property after the buyer breaches their purchase agreement and the property's value has declined below the price set in the purchase agreement, the seller has incurred a **loss in value** which is recoverable from the buyer. However, the amount of future value decline recoverable after the buyer's breach is limited to two time periods:

- the initial decline in value below the purchase price during the period **before the breach**, which is recoverable as *general damages* or more commonly called a *price-to-value loss*; and
- any further decline in value **after the breach**, which is recoverable only if the buyer **interferes** with the seller's resale effort, also called *special damages* or more commonly called *additional damages*, damages being money. [CC §3307]

The price-to-value loss on the date of breach is recoverable by the seller whether the property is retained, remarketed or resold by the seller.

During periods of reduced regional economic activity, the boom-bust cyclical nature of real estate sales typically causes California property values to drop dramatically below the price the buyer agreed to pay just a few months earlier.

Further, the intangible impacts on a property's market value, due to its "shop-worn" listing status and the "fall-out syndrome" of a lost sale, give the property an aura in the local real estate market which negatively affects some buyers and their brokers. This aura is often reflected in a further dampening of the property's value on the date of breach. [**Bouchard** v. **Orange** (1960) 177 CA2d 521]

To limit the breaching buyer's liability, the seller's loss on a resale at a price lower than the price agreed to by the breaching buyer is limited to the amount of the value decline which occurs by the date of the buyer's breach, not the date of resale. Any further decline in value after the date of breach to the date of resale (or trial, if the property is not yet resold) is recoverable only if the buyer interferes with the seller's diligent resale efforts.

Same or greater price on resale

When property is resold for the same price agreed to by a breaching buyer, or more, and the net proceeds from the resale are the same or the cash equivalent, or more, the price-to-value decline on the date of breach is no longer recoverable. With equal or greater net proceeds on a resale, the seller incurs no money loss, called *general damages*, since he has no loss of value to recover.

To set the dollar amount of the *price-to-value loss* on the date of breach, any "noncash" terms for payment of the purchase price by the breaching buyer and any "noncash" terms for payment of the resale price are adjusted to their **cash equivalency**.

For example, if terms for payment of a sale price include a seller carryback note, the principal amount of the carryback note is adjusted downward to reflect any discount required to convert the carryback paper to its cash equivalent, i.e., its present worth in cash.

Interfering with the resale

A seller might **diligently remarket** the property and still be unable to resell it due to interference from the breaching buyer. Buyer interference with resale efforts usually consists of filing a *specific performance action* and recording a *Notice of Lis Pendens*, or taking possession and refusing to vacate.

When the **breaching buyer interferes** with the resale, the seller recovers any decline in the property's value after the date of breach until the buyer stops interfering with the seller's resale efforts.

For example, a buyer sues a seller seeking specific performance of the purchase agreement. The seller claims the buyer breached the purchase agreement by failing to satisfy contingencies as scheduled. The buyer claims the seller breached when he canceled, thus *excusing* the buyer from further performing. The buyer sues to recover the property and records a **Notice of Lis Pendens**, which *clouds* the marketability of title.

Ultimately, the buyer is held to have breached the agreement and the lis pendens is removed from the record, called *expungement*.

A seller, whether he attempts to resell the property or retains it, generally bears the risk of any fluctuation in the value of the property after the buyer breaches. The breach is the cutoff date for recovery of a decline in value, unless the buyer later interferes.

However, the risk of loss due to a decline in value after the date of breach is shifted to the buyer until the date title is cleared of the recorded lis pendens if the recording interferes with the seller's prompt and diligent efforts to resell the property. [**Askari** v. **R & R Land Company** (1986) 179 CA3d 1101]

Natural-consequence expenses

A seller who takes the property off the market or is not prompt and diligent in his efforts to remarket and resell it after the buyer's breach is limited in his recovery of money to his **actual transactional expenses** and any **operating expenses** incurred to fulfill the seller's performance under the purchase agreement up to the time of the buyer's breach.

Recoverable money losses the seller might incur as **transactional expenditures** include:

- escrow and title charges;
- lender charges for beneficiary statements or payoff demands;
- lender or carryback seller charges to process the buyer's credit clearance, loan application or loan assumption; and
- other expenses and property reports incurred in reasonable reliance on the buyer's full performance of the purchase agreement.

However, **ownership and operating expenses** incurred by a seller who chooses to either retain the property or delay reselling the property are not recoverable. The seller, as the owner of the property, remains responsible for the expenses of carrying and maintaining the property since these expenses are not incurred by the seller due to a buyer's agreement to purchase or a breach by the buyer. These expenses are incurred because the seller owns the property.

However, some **operating losses** incurred by a seller due solely to his *compliance* with the terms of a purchase agreement are recoverable, including:

- the seller's *relocation expenses* to reoccupy the property if he vacated after all contingencies allowing the buyer to cancel were eliminated;
- rental income lost after the breach on *units left vacant or vacated* by the terms of the purchase agreement;
- a *crop revenue loss* due to the planting season having passed at the time of the buyer's breach; and
- a price drop on the *late harvest* of a crop due to the buyer's breach. [**Wade** v. **Lake County Title Company** (1970) 6 CA3d 824]

Replacement property

Consider a buyer who enters into a purchase agreement knowing the seller intends to acquire replacement real estate with the net proceeds from the sale. After all the buyer's contingencies are eliminated and no uncertainties remain about the buyer's full performance, the seller enters into a purchase agreement to buy replacement property without conditioning his purchase on the "sale of other property."

The buyer then breaches and the seller is unable to complete his purchase of the replacement property. The seller incurs expenses and losses to avoid liability for having unconditionally agreed to purchase the replacement property.

Expenses incurred on the replacement property transaction are recoverable since:

- the buyer knew when he entered into the purchase agreement that the seller intended to contract to purchase replacement property based on the buyer's agreement to purchase; and
- the seller agreed to purchase other property in reasonable reliance on his buyer closing the sales escrow since all contingencies had been removed and no obstacles to closing existed, except for the breach. [**Jensen** v. **Dalton** (1970) 9 CA3d 654]

Operating losses during the resale period

A seller who, after his buyer breaches, promptly takes steps to diligently remarket the property for sale may recover his operating expenses and carrying costs of the property incurred **after the date of breach**, subject to offsets for rent credit, owner's use, etc.

Recoverable operating losses and carrying costs are limited to those the seller incurs during the period beginning on the buyer's breach and ending on the earlier of:

- the date a **resale closes**;
- the **trial** judgment on the breach; or
- the date of **withdrawal** of the property from the resale market.

The seller who decides to promptly resell the property and then recover any losses from the buyer has a duty to the breaching buyer to limit the operating and ownership losses, called *mitigation of damages*. To do so, the seller must take immediate steps to market the property for resale within the shortest possible time. [**Spurgeon** v. **Drumheller** (1985) 174 CA3d 659]

To begin calculating the seller's net loss, the seller's costs of maintaining his ownership are totalled. However, the recoverable operating expenses and carrying costs of the property incurred by the seller during the resale period are limited to operating and ownership expenses understood by the buyer to exist at the time he entered into the purchase agreement.

However, the buyer is **due a credit** for the rental value of the seller's occupancy, called *implicit rent*, and any rental income received by the seller from the property after the buyer's breach.

Thus, for a seller to recover on-going losses incurred to carry the ownership of the property before resale or trial, a full accounting of income, expenses and the carrying costs of financing is required.

Interest on recovered losses

A seller is also **entitled to interest** on the losses and expenditures he recovers for the decline in the property's value, expenses of the breached transaction, resale related expenses and the carrying costs of the property during the resale effort. [CC §3307]

Unless the purchase agreement states otherwise, the interest is collectable at the legal annual rate of 10%, accruing from the date the recoverable loss or expenditure was incurred, called *prejudgment interest*. [CC §3289(b)]

If the seller **retains the property**, no property operating or value losses after the breach are recoverable on which interest can accrue.

For the seller who **diligently remarkets** the property for resale, recoverable resale costs and out-of-pocket carrying costs of the property not offset by rental income or the rental value of the seller's use of the property accrue interest from the date of each expenditure.

Had the buyer performed and closed escrow, the seller would no longer own the property. The seller would have received the net sales proceeds for his equity in the property.

Since escrow did not close and the seller did not receive the net sales proceeds for his equity, the question of whether he is entitled to interest on his **net equity** turns on the seller's use of the property at the time the purchase agreement was entered into.

For example, a **seller's use** of the subject property falls into one of two categories:

- **income-producing property** used as the seller's residence or to house the seller's trade or business (implicit rent) or held out as a residential or nonresidential rental; or
- **nonincome-producing property**, such as vacant land or the seller's vacant residence.

Rents received from income producing property are the *economic equivalent* of **interest** on the dollar amount of the equity. Thus, for the seller to also receive interest on his equity in income-producing property until it resells would be a nonrecoverable windfall, a double recovery on his equity in the form of both interest and rent, which are **economic equivalents**.

The seller who occupies the property until it is resold is charged for the value of his use, called *implicit rent.* The amount of **implicit rent** is an offset against all money recoverable from the breaching buyer, including interest on the seller's equity.

For vacant unused land or the seller's vacant residence, a breach by the buyer again fails to convert the seller's equity into cash or cash equivalent. Thus, the seller temporarily retains ownership of the equity, which may be increasing, decreasing or remaining the same depending on price fluctuations for the property's market value until it is resold.

Since the resale seller cannot recover his equity in vacant property from the breaching buyer (except by specific performance), can interest be collected on the equity?

First, any interest due on the dollar amount of the net equity can only accrue from the **scheduled closing date** of the breached contract — the date the benefits from the breached sale in the form of cash for the seller's net equity would have been received by the seller — up to and ending on the **date of resale or trial**. Any interest due accrues at the legal rate of 10%. However, if the seller agreed to an installment sale, the note rate for the carryback paper would be the controlling rate.

Next, if the breached purchase agreement contains a provision limiting the dollar amount of losses the seller can collect, the losses recoverable would be controlled by the agreed-to limit, except for the accrual of interest which would be an additional amount. [See **first tuesday** Form 150]

Thus, when the buyer breaches an agreement to purchase vacant, nonincome-producing property, interest is due on the net sales proceeds the seller would have received on the sale, until the property is resold.

Chapter 30 — Liquidated damages provisions

This chapter is a survey of the unenforceability of liquidated damages provisions in real estate purchase agreements and the limitation on a breach to the recovery of actual money losses.

Windfalls and responsibility for losses

Everyone, by the time they reach the age of capacity to contract, understands the fundamental premise that when you wrongfully cause another person to lose money, you are responsible for *repayment* of the loss. This economic concept was codified for real estate transactions in 1872 and remains intact today. [Calif. Civil Code §3307]

However, an equally fundamental premise holds that windfalls are abhorred by all since they are unearned.

These two precepts are frustrated by the inclusion of a **liquidated damages provision** in a purchase agreement. Use of a liquidated damages provision is an attempt:

- to *limit a buyer's responsibility* for payment of losses he inflicts on another; and
- to *provide the seller with a windfall* at the buyer's expense.

The contractual liquidated damages provision creates aberrations in the natural expectations held by everyone in the transaction.

For instance, a seller expects to lose nothing of value in exchange for what is the buyer's good-faith deposit should the buyer fail to close the transaction. However, the buyer expects a refund of his good-faith deposit if he does not acquire the property.

Ironically, the listing agent looks at the liquidated damages provision in the purchase agreement as a way to be paid a small fraction of the fee he earned. Erroneously, brokers do not bargain for payment of a full fee by the buyer when the buyer breaches the purchase agreement. All of these expectations are without concern for the amount of money the seller and agents lost, or that the breaching buyer caused the losses and should reimburse them.

A **listing agent**, being charged with a *duty of care* for his seller, needs to understand the contractual and financial nature of his seller's position under a purchase agreement so he can properly advise the seller when the purchase agreement is breached by a buyer. When the buyer breaches and the seller cancels the purchase agreement, the seller still **owns the property**, although with no further claim by the buyer of a right to acquire it.

Also, the **good-faith deposit**, even if released to the seller after contingencies have been removed, is the buyer's money until:

- the buyer *receives consideration* (the property); or
- the deposit is *offset by reimbursement* to the seller for his **actual money losses** suffered due to a breach by the buyer.

The seller's purported loss of prospective buyers and prior market synergies and the infliction of seller frustration and inconvenience, all due to the buyer's breach, are not *money losses*. Thus, these ancillary or collateral situations leave the seller with nothing to collect.

However, the seller's agent properly focuses on **resolving a breached** and failed sales transaction by immediately turning his attention to assisting his client to "clear out" the transaction so the property can be remarketed to another prospective buyer. The listing agent is still obligated to locate buyers under the seller's exclusive right-to-sell agreement, unless it has expired.

Thus, cancellation instructions need to be given to escrow to terminate the breached purchase agreement and escrow instructions, unless the resale value of the property has dropped or the seller has reason to pursue a specific performance action and forego reselling or retaining the property. [See Chapter 29]

Money losses reimbursed

What is the listing agent to do about a buyer's good-faith deposit when the buyer breaches a purchase agreement?

While a listing agent's knee-jerk reaction may well be to get the buyer's funds to the seller so half of the deposit will be earned as a brokerage fee, the first reasonable step to be taken by the agent is to analyze the extent of the seller's loss of money now that the sales escrow is dead. The buyer owes the seller the seller's actual money losses since they are expenditures which will not be reimbursed by a resale. Thus, the seller has a *claim* on the buyer's good-faith deposit as the **primary source for recovery** of the losses.

Fortunately for all, the seller's recoverable losses are quite straightforward for calculating the amount of the demand to be made on the buyer. Getting all the figures for the demand will take time and effort. Presuming, as the listing agent must, that the seller will not interfere with the listing and allow the agent to locate a new prospective buyer, the property will be resold in the near future.

A seller's net sheet used to lay out the net proceeds received on the closing of a **resale**, when compared to a seller's net sheet estimating the net proceeds the seller would have received on the **canceled sale**, will present a fairly accurate representation of the money losses the seller incurred due to a decline in property value and the transactional costs not reimbursed by the resale.

The ongoing operating and carrying costs, if the property remains **rented or used** by the owner prior to resale, generally are not recoverable expenses. The actual or implicit rent usually exceeds the operating expenses and carrying costs of the property until the closing of the resale. Also, operating income and expenses usually are not altered due to the terms of the purchase agreement. Hence, little loss, if any, exists for the seller to recover on his continued ownership of the property.

Demands, challenges and limitations

The seller making a demand on a breaching buyer for the deposit is confronted with a decision as to when to make the demand. The seller may **make a demand** for all or a portion of the good-faith deposit at either:

- the *time of the breach*; or
- *after closing a resale* of the property when a loss, if any, is known.

To analyze the demand process, first look to the provisions of the purchase agreement used for the sale of a **one-to-four unit residential property** to a **buyer-occupant**. If a liquidated damages (forfeiture)

provision is included in the purchase agreement and the buyer and seller both initialed the provision, they have actually agreed that the buyer's good-faith deposit is to be forfeited to the seller on a breach by the buyer.

However, liquidated damages provisions are initially enforceable by a seller only to **set the limit** of the buyer's liability to the seller. Liquidated damages provisions place a ceiling on the seller's recovery at the amount of the deposit agreed to be forfeited.

For example, if the buyer demands the deposit be refunded, the seller becomes obligated to provide an accounting showing his losses **equaled or exceeded** the amount of the deposit in order to keep the entire deposit. Should the losses be **less**, the seller is not entitled to the entire deposit. Thus, the seller can recover the money he has lost up to the total amount of the deposit referenced in the agreed liquidated damages provision, no matter the amount of the deposit.

When a liquidated damages provision exists, the proper initial reaction of the seller and the listing agent is to make a demand on the buyer for the entire good-faith deposit if it does not exceed 3% of the price since this amount of forfeiture is *presumed valid*.

Once the demand for the forfeiture has been made on the buyer — and it will be made without concern for the actual money losses the seller may have experienced or will experience on a resale — the seller merely waits for the buyer's response. If it is positive and the funds are released to the seller, the seller has won the war. Hopefully for the seller, the buyer will not later realize that the seller's actual money losses were less than the amount released and then make a demand for a refund.

However, if the buyer's agent and the buyer are as well informed as the seller and listing agent, the buyer will **challenge** the liquidated damages provision as *voidable* and demand a return of his deposit. Thus, the provision as a forfeiture is unenforceable since the provision's validity is a *rebuttable presumption*.

The seller must have sufficient losses to justify his retention of the entire liquidated damages deposit. In other words, the amount of the deposit, always being arbitrary in amount and coincidental to the price paid, has no relationship to the losses the seller might suffer on the buyer's breach.

Calculating his losses

If challenged, the seller, confronted with the buyer's challenge that the liquidated damages provision is **voidable**, is back to square one. Namely, the seller must now calculate his losses on the resale and his permissible interim operating and carrying costs of the property prior to a resale as though:

- no liquidated damages provision existed in the purchase agreement;
- the amount of the deposit for liquidated damages was more than 3% and thus initially presumed invalid;
- the liquidated damages or liability limitation provision placed a ceiling on the buyer's liability for the seller losses; and
- no provision limiting recovery existed in the purchase agreement restricting the seller's right to recover all his losses.
- Under any of the above scenarios, the seller is to itemize his money losses, which include:
- any decline in the property's value by the time of the buyer's breach;
- the seller's transactional costs incurred on the lost sale which are not recoverable on a resale; and

- any increased operating costs or rent losses caused by the purchase agreement with the buyer and incurred prior to the resale.

The buyer will cover these itemized losses from the good-faith deposit up to any dollar limitation set by a liquidated damages or liability limitation provision in the purchase agreement.

The seller who seeks to **recover losses caused by the breaching buyer** when the buyer asserts his right to pay only the seller's actual money losses, needs to:

- proceed to resell and close a resale of the property rather than retain the property;
- calculate the total amount of the price-to-value loss, lost transactional expenses and the loss of nonvalue-added improvements or repair expenditures;
- make a demand on the buyer for the amount of the itemized money losses; and
- if not paid, pursue collection of the lost money and a release of the amount from the buyer's deposit, subject, of course, to any agreed limitation on the dollar amount of the buyer's liability for his breach.

Challenging the validity of a forfeiture

A buyer and his agent, when the seller demands any of the **buyer's good-faith deposit**, need to understand:

- the funds *belong to the buyer* until escrow closes, which will not occur due to the buyer's breach;
- the seller has a *claim against the deposit* for recoverable losses; and
- the buyer is to make a demand on the seller for a statement of *itemized losses* before the buyer will pay any compensable losses incurred by the seller.

Thus, when a liquidated damages provision exists on the sale of a one-to-four unit residential property which is initialed by both the seller and buyer, the buyer's demand for an itemization of the seller's money losses constitutes a *legal challenge* which rebuts the presumed validity of a forfeiture provision for deposits not exceeding 3% of the purchase price.

On making the request of the seller for an accounting, the buyer awaits the seller's response. If the seller fails to respond with an accounting, he either did not incur a recoverable loss or waived any claim he may have to recover his losses.

Limiting the breaching buyer's liability

Without a liquidated damages provision or contract liability limitation provision in the purchase agreement, a seller is entitled to recover the entire amount of his money losses caused by the buyer's breach.

Conversely, the seller is limited in his recovery to the amount of the forfeitable deposit should the purchase agreement (for the sale of one-to- four residential units to a buyer-occupant) include an initialed liquidated damages provision or a contract liability limitation provision.

In either case, if an **accounting** is sought by the buyer for the seller's recoverable money losses, the seller must present an accounting in order to be reimbursed for them.

When an initialed liquidated damages provision is included in a purchase agreement, the breaching buyer avoids the forfeiture called for by challenging the *presumed validity* of any amount **up to 3%** of the purchase price.

However, for the seller to enforce a forfeiture of any portion of a deposit **exceeding 3%** of the purchase agreement price, the seller must challenge the *presumed invalidity* of the excess by demonstrating in an accounting that his losses on the sale exceeded 3% of the purchase price.

Thus, the liquidated damages provision has a "split-personality" aspect. The responsibility for challenging the *presumed validity* of a forfeiture of 3% or less is the buyer's, and the responsibility for challenging the *presumed invalidity* of a forfeiture of more than 3% is the seller's.

In general, liquidated damages provisions, other than on the sale of one-to-four residential units to a buyer-occupant, are presumed to be *valid*. However, they are classified as *forfeitures* and are unenforceable if they do not provide an amount which bears some **reasonably close relationship** to the actual losses the seller will incur due to harm inflicted by the buyer on a default.

When the amount of the forfeiture exceeds the seller's losses, the buyer can **void** the provision as unreasonable. Thus, the liquidated damages provision is *voidable* as it is only presumed to be valid if the amount is reasonably close to actual losses.

Liability ceiling or forfeiture

If a buyer and seller do not agree to either a liquidated damages provision or a contract liability limitation provision, then the buyer who enters into such a purchase agreement and breaches will be liable for an **unlimited amount of losses** incurred by the seller due to the buyer's breach. In the economic environment of a stable resale market for homes or one of generally rising or fast rising prices little risk is taken by a buyer when entering into a purchase agreement without a ceiling on his liability exposure.

However, it is for buyers in a static market or one following a peak in prices when mortgage rates rise that the buyer's agent needs to take *utmost care* to explain the need for a **ceiling on liability** exposure.

As for the listing agent, he should advise his seller in times of weak or weakening pricing power to avoid agreeing to a ceiling on the buyer's liability and to get a huge deposit.

Seller breach by refusal to refund

Consider a buyer of a single family residence who has entered into a purchase agreement containing an initialed, liquidated damages provision.

Prior to closing, the buyer waives all contingencies and releases his original and additional good-faith deposit to the seller in an amount in excess of 3% of the agreed price. At the time of closing, the buyer decides not to close escrow on the purchase of the property.

The seller promptly remarkets the property, accepts an offer and quickly closes a resale of the property, but at a slightly lower price. The buyer then makes a **demand on the seller** to return that portion of the deposit now held by the seller which exceeds the seller's losses. The breaching buyer is willing to cover the seller's loss due to the reduced amount of net proceeds on the resale.

The seller rejects the buyer's demand for a refund, claiming the funds released were option money which he is entitled to keep as consideration for his *irrevocable offer* to sell the property to the buyer, which the buyer did not exercise by closing escrow.

However, the liquidated damages provision in the purchase agreement indicates the agreement is bilateral. The purchase agreement called for a forfeiture of the deposit should the buyer fail to close escrow, the antithesis of an option agreement which is unilateral and by its nature contains no forfeitures. Thus,

the seller's defense for keeping the buyer's deposits as option money consideration for granting an option is a non-starter.

Also, the seller did not attempt to show that his losses caused by the buyer's breach equaled or exceeded the buyer's deposits. The seller did not produce closing statements for either the lost sale or the resale, lost transactional expenses, nonvalue-adding expenditures for repairs or maintenance, or any recoverable operating costs for carrying the property or lost rental value until the close of the resale.

Here, the liquidated damages provision becomes a **promise by the seller** to refund the portion of the deposit which exceeds the seller's recoverable losses, due to either:

- a buyer's challenge of the forfeiture's reasonableness; or
- the forfeiture amount being in excess of 3% of the purchase price.

Thus, the seller's failure to refund (or release) the amount exceeding his losses is a **breach by the seller** of the liquidated damages provision and the purchase agreement. [**Allen** v. **Smith** (2002) 94 CA4th 1270]

Had the purchase agreement not contained a liquidated damages provision or other contractual liabilities limitation, the seller would still have been **limited to collecting** no more than his actual losses. Thus, the excess amount of the buyer's deposit over the seller's losses must always be refunded by the seller or released from escrow to the buyer.

Court-ordered forfeiture not enforced

Consider a buyer and seller of a one-to-four unit residential property who enter into a court-ordered settlement agreement to resolve a dispute over their purchase agreement by agreeing to close escrow. The settlement agreement contains a forfeiture provision calling for the release of the buyer's good-faith deposit to the seller if the buyer does not complete the sale as agreed.

However, the buyer is unable to secure purchase-assist financing and cancels escrow, a breach of the settlement agreement since closing escrow was not contingent on his obtaining a loan.

The seller seeks to recover the buyer's good-faith deposit. However, the seller has incurred no loss due to the buyer's failure to perform.

The buyer claims the seller cannot enforce the forfeiture provision in the court-ordered settlement agreement since any provision agreeing to the forfeiture of the good-faith deposit is limited by contract law to a **provable loss**.

The seller claims the forfeiture provision is enforceable without a proof of loss since the provision is contained in a court-ordered settlement agreement between the buyer and seller, not in a privately negotiated real estate purchase agreement.

Here, as in all forfeitures of money arising out of any real estate transaction, the seller may not enforce the forfeiture provision and recover the buyer's good-faith deposit without a showing of his actual money losses. The court-approved settlement agreement is a contract agreed to by the buyer and seller and contract law prohibits the enforcement of liquidated damages provisions in real estate purchase agreements, unless the seller incurs a loss and limits recovery of the loss. [**Timney** v. **Lin** (2003) 106 CA4th 1121]

Chapter 31 — Arbitration: the independent beast

This chapter presents the adverse impacts created by agreeing to a binding arbitration clause in a real estate listing or purchase agreement.

Rights to correct a decision lost

The trend among real estate agents regarding dispute resolution, encouraged since 1978 by trade unions, arbitration associations and the courts, has been to avoid the California court system by agreeing to resolve disputes involving the purchase or leasing of real estate and agency relationships through *binding arbitration*. The wisdom of this trend in real estate related contracts is under increasing attack.

Many pre-printed brokerage and purchase agreements include a boilerplate **arbitration provision**. The arbitration provision included in a purchase agreement, listing or lease agreement **forms a contract** with an arbitrator. Thus, the provision forms an agreement between the person who initials the provision and the arbitrator, an agreement separate from the purchase agreement which contains the provision. [**Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395]

To be enforceable, the arbitration provision must be initialed by the person against whom the provision is being enforced. Thus, an arbitration provision is enforceable against any person who initials the provision, even if the person is the only one to initial it. [**Grubb & Ellis Company** v. **Bello** (1993) 19 CA4th 231]

*Editor's note — **first tuesday's** purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy to reduce disputes by making them less economically feasible.*

An **arbitration provision** in a real estate purchase agreement, listing or lease:

- is an arbitration agreement between the arbitrator and each person who agrees to be bound by the provision [Calif. Code of Civil Procedure §1297.71]; and
- defines the arbitrator's powers and the limitations on those powers.

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the American Arbitration Association.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is **binding and final**. Without judicial review of an award in an arbitration action, the parties cannot be assured the award will be either **fair or correct**.

Arbitration's hype

Arbitration proceedings are reputed to be swifter and less costly than trials. Also, arbitrating disputes rather than litigating them eases the burden on the court system, and thus the taxpayer. Further, a public airing of "dirty laundry" produced in court filings and proceedings is avoided.

However, arbitration does not much live up to its reputation for being inexpensive or expedient. Filing fees for arbitration are high compared to filing fees for litigation. Unlike judges who are paid by the tax-

payer, the arbitrator's charges must be paid by the loser. Additionally, the winner's attorney fees are paid by the loser when an attorney fee provision exists in the purchase agreement, lease or listing agreement involved.

Arbitration proceedings draw out for years when the dispute becomes complicated, just as in litigation. Also, a legitimate disagreement with the arbitrator's award as inconsistent with controlling California law, when called for in the powers granted the arbitrator by the arbitration provision, frequently leads to litigation in an effort to get the result attainable had the action been filed in a court of law in the first place.

Bizarre results not correctable

Consider a seller who contacts a brokerage office to list his property for sale. The sales activity is delegated to the broker's agent who procured the listing, customarily called the *listing agent*.

The seller and listing agent sign a listing agreement containing a provision calling for disputes to be submitted to binding arbitration — no judicial oversight permitted.

A buyer is located and an offer is obtained by another agent employed by the same broker, customarily called the *selling agent*. Both the agents and the broker are aware the buyer is financially unstable and may encounter difficulties closing the transaction.

However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a contingency provision by the selling agent who prepared the offer for the buyer. A contingency would have authorized the seller to cancel the purchase agreement if the buyer's credit had been found to be unsatisfactory.

When the listing agent, acting alone, submits the buyer's offer to the seller, the buyer's financial status is not discussed or disclosed, orally or in writing. The supervising broker fails to catch or correct the oversight.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent will receive a share of any fee their broker may receive on the sale. Each agent's share is based on formulas agreed to in their respective written employment agreements with the broker.

Later, the buyer fails to close the transaction due to his disabling financial condition. The seller discovers that the listing agent, broker and selling agent all knew of the buyer's financial condition and failed to advise him of this fact. The seller makes a demand on the broker and both agents for his losses on the failed transaction, claiming the buyer's financial condition was a material fact in the transaction which the agents and broker knew about and failed to disclose.

The dispute is submitted to binding arbitration since a court action is barred by the arbitration provision in the listing agreement.

The arbitrator awards money damages to the seller based on the professional misconduct of the listing agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being **vicariously liable** as the employer of the listing agent who failed to disclose.

Further, the arbitrator issues the seller a money award against the selling agent ruling the selling agent and the listing agent were "partners" since they would share in the fee the broker was to receive on the transaction. Thus, the selling agent is held **liable as a partner** of the listing agent for the seller's money damages resulting from the misconduct of the listing agent.

The selling agent then seeks to vacate the portion of the arbitration award holding him liable as a "partner" of the listing agent, claiming the arbitrator incorrectly applied partnership law to a real estate agency and employment relationship.

Can the award against the selling agent be corrected by a court since the arbitrator wrongfully applied partnership law?

No! An arbitrator's award, based on an erroneous application of law, is **not subject to judicial review** since a judicial review of the arbitrator's award was not included as a condition of an award in the arbitration provision. The arbitrator acted within his powers granted by the arbitration provision, even though he applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement cannot review the arbitrator's award for **errors of fact or law** even if the error is obvious and causes substantial injustice. [**Hall** v. **Superior Court** (1993) 18 CA4th 427]

Grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator **exceeded his authorized powers**;
- the arbitrator **acted with fraud** or corruption;
- the arbitrator **failed to disclose** grounds for his disqualification;
- the award was **procured by corruption**, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially **prejudiced the rights** of the party. [CCP §1286.2]

An arbitrator, unlike a judge in a court of law, is **not bound by the rules of law** when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, his erroneous award, unlike an award of a court, cannot be corrected by any judicial review. The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review;" or
- the arbitrator applied the wrong law and in so doing exceeded his powers which had been limited to applicable law by the arbitration provision.

Otherwise, no judicial oversight exists, by petition or appeal, to correct an arbitrator's erroneous award.

The arbitrator's award

Consider a buyer and seller of real estate who enter into a purchase agreement on a form which contains an arbitration clause. They **both initial** the provision.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market.

Motivated by his belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer seeks only to recover his **money losses** amounting primarily to the difference be-

tween the purchase price he agreed to pay for the property and the increased value of the property on the date of the seller's breach, called *money damages*.

The buyer no longer wants the property and does not seek *specific performance* of the purchase agreement, even though the seller still owns the property.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn.

The arbitrator then issues an award in favor of the buyer.

However, the arbitrator does not award the buyer his money losses as asked for by the buyer. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement as well as the increased value at the time of the seller's breach.

Instead of the requested money award, the arbitrator's award grants the buyer the **right to purchase the property** for a price equal to its current fair market value.

The buyer now petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded his powers by awarding a result not contemplated by the purchase agreement nor sought by the parties, i.e., the right to acquire the property at a different price even though the buyer does not want to acquire the property.

Did the arbitrator exceed his powers, act corruptly or prejudice the rights of the parties by awarding an *equitable remedy* (specific performance) which was in conflict with the purchase agreement (different price) and beyond any expectations of either the buyer or the seller?

No! The arbitrator was not corrupt and did not exceed his powers in awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's **(mis)interpretation** of the purchase agreement and the law.

Basically, the remedy awarded a buyer by an arbitrator in binding arbitration is **not reviewable by a court of law**, as long as the remedy has "some remotely conceivable relationship" to the contract. [**Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362]

When individuals enter into a purchase agreement, each person has expectations about his and the other person's performance as defined by the terms of the agreement and set by existing law.

Yet by agreeing in the purchase agreement to binding arbitration, not only is a person **forced to accept** an arbitrator's incorrect application of law, he is forced to proceed with arbitration and accept **an award impossible to predict**.

As the dissent in *Advanced Micro Devices, Inc.* points out, a bizarre interpretation by an arbitrator of the agreement underlying a dispute, coupled with a blatant error of law, might result in an arbitration award "ordering the marriage of the disputing parties' first-born children."

An arbitrator has great latitude in making decisions since he may use his own discretion and does not need to follow the mandates of regulations, case decisions and codes.

Arbitrator's authority to enforce

Consider two partners in a real estate venture whose partnership agreement contains a boilerplate arbitration clause stating any dispute arising out of the agreement will be submitted to binding arbitration without judicial review.

On dissolution of the partnership, a dispute arises regarding disposition of the property, which is arbitrated. On issuing the award, the arbitrator includes the appointment of a receiver to supervise the sale of the partnership's property, rather than an award limited to calling for the property to be sold.

One of the partners seeks to vacate the arbitration award claiming the arbitrator exceeded his powers by appointing a receiver to sell the partnership's property.

Did the arbitrator exceed his powers by appointing a receiver to enforce his award?

Yes! The portion of the arbitration award appointing the receiver is invalid. An arbitrator lacks authority to **enforce his award** for the sale of the property, which is what the appointment of the receiver is designed to do.

The arbitration award must first be **reduced to a court-ordered judgment** before enforcement. On issuing an award, the person receiving the award files a petition with the court to **confirm** the award. On confirmation at a hearing on the petition, judgment is entered in conformance with the award.

It is the **judgment** which is enforced, not the arbitrator's award.

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator **exceeds his powers** when he attempts to also enforce his award — conduct reserved for a court of law after the award has been reduced to a judgment by the court. [**Marsch** v. **Williams** (1994) 23 CA4th 238]

An arbitrator also exceeds his powers when he **imposes fines** on a party to an arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose **economic sanctions**, such as penalties and fines.

However, had the arbitration agreement authorized the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards. [**Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52]

Attorney fees as a power

Now consider a buyer and seller who enter into a real estate purchase agreement containing both an arbitration provision and an attorney fee provision. The attorney fee provision entitles the buyer or seller who prevails in an action to be awarded his attorney fees.

The buyer terminates the purchase agreement and seeks to recover all his transactional costs, claiming the seller has breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision in the purchase agreement.

The seller seeks a correction of the arbitration award in a court of law claiming the arbitrator exceeded his powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator did exceed his powers by failing to award attorney fees. The seller as the prevailing party was entitled to an award of attorney fees by a provision in the purchase agreement which was the

subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator must award attorney fees to the prevailing party. [**DiMarco** v. **Chaney** (1995) 31 CA4th 1809]

The attorney fee dilemma has a flip side. Not only must the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator must determine the amount of the attorney fees to be awarded, an amount which is not subject to court review. [DiMarco, *supra*]

Avoiding arbitration

Consider a broker or agent who becomes a member of a local trade association. As part of the **membership agreement**, he agrees to binding arbitration for disputes arising between himself and other association members.

The arbitration panel who hears and decides disputes between members is composed of other members of the local association who have little to no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are to consist of "neutral" arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

However, the primary problem with **arbitration proceedings** heard by a local association's arbitration panel is the feeling held by most brokers and agents who are compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are violated.

Further, by becoming a member of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so and still comply with their broker's need to satisfy the local trade association's annual monetary demands arising out of their association with the broker, they can pay "nonmember dues" and become "paid nonmembers." [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

Mediation

Instead of immediately resorting to the costly and adversarial process of litigation, in recent years the trends in real estate sales indicate disputants favor the use of *mediation*.

Many listing and purchase agreements contain binding arbitration agreements as an alternative method of litigation. [See **first tuesday** Form 150]

However, arbitration is final and unappealable. Thus, it is a double-edged sword as disputants have no assurance the arbitrator's award will be fair or correct. Only with mediation's familiar arena of offer and counteroffer beween the feuding parties, as encouraged by the mediator, do they have the ability to come

to a mutually crafted and agreed-to solution, the main psychological advantage mediation has over actions in litigation or arbitration.

Litigation is, at its heart, a deeply adversarial process which ends with a spurned “loser” who can then move on to draw out the dispute in a time-consuming and costly appeals process. **Arbitration** is a similar action, shunting the disputants into “winner” and “loser” roles. In arbitration, all the power of the decision is placed upon the arbitrator. Even if the arbitrator bases his decision on an incorrect interpretation of the facts or the law, neither party has recourse to change the erroneous decision. [Hall, supra]

The cost of **mediation** has been deemed another major benefit of the process. Consider also the time involved in mediation versus the time involved in litigation or arbitration. Litigation can be drawn out for years with various pre-trail, discovery, and appeal processes, all while the attorney’s billable hours soar. Arbitration may also last years and in addition to contracted-for attorney fees, the loser is responsible for paying the arbitrator’s fees.

However, mediation is typically a quick process lasting a few hours to a few months, depending on the number of disputants and the complexity of the dispute. There are no lengthy waits for court hearings or the need for witnesses since the resolution is in the hands of the disputants themselves.

In addition to these benefits, the use of mediation also provides a solution to a dispute without adding to and falling subject to the backlog of cases burdening the legal system.

Most importantly, mediation works. The Los Angeles Superior court system reports that 63% of cases ordered into mediation are resolved. Nationwide, the mediation success rate ranges between 60%-90%. [Final Report of Colorado Governor’s Task Force on Civil Justice Reform, Exhibit 7]

Mediation does have its **limits**. In real estate matters, mediation is limited to resolving disputes involving buyers and sellers. Landlord-tenant disputes and trust deed defaults are largely based on very specific statutory requirements for performance which are either satisfied or unsatisfied, leaving little room for negotiation. Mediation is a tool best used by disputants in sales of property and agency disputes.

Chapter 32 — Vesting the ownership

This chapter introduces the various vestings for holding title, the ownership rights reflected by the vestings, and their termination by any right of survivorship on death of a co-owner.

Possession and transfer rights

All parcels of real estate have a recorded history. California's real estate history began with its admittance into the Union, when the United States of America became the initial owner of all the land. Titles were "proven up" by individuals in federal courts or with government agencies who issued *certificates of title* based on comparable rights held by the individuals under prior Spanish, Mexican or California sovereign law.

Thus began the **recorded history of title** to each parcel in California. Parcels are now identified by the assessor of each county by a parcel number.

A conveyance by the vested owner of a parcel effectively transfers title to the next owner if the person conveying "title" holds title under a prior conveyance transferring title into his name. Thus, for each parcel a linkage exists in title from the beginning of the state of California to the present. The "chain of title" for a parcel reflects a conveyance by each person who previously took title to the property, from themselves to the next vested owner of title, and on to the present holder of title.

The initial focus for an analysis of a transfer of title in a sales transaction is on the person who is conveying title, not the new owner who is taking title. If the person conveying does not hold a good and **marketable (insurable) title** to the property and have the authority to convey it, the transfer to the new owner is defective, if not ineffective.

Today, the ability of the current owner to transfer title is the concern of the title companies. Title insurers issue policies covering the risk regarding whether the transfer of the ownership interest bargained for by the new owner has occurred. Title company analysis of this *conveyancing risk* is based on the nature and validity of the **present owner's vesting**, usually established when that owner took title.

The vesting used to take title when a person acquires ownership establishes the rules controlling his later conveyance of an interest in the property to another.

Thus, the text of this chapter focuses on the **vesting used to acquire** an interest in real estate under a deed, lease or trust deed.

The time for setting the vesting

Consider a buyer who has entered into a purchase agreement and escrow instructions. The purchase agreement states the buyer will take title in the condition agreed and as insured by a title insurer under a policy of title insurance. The **precise vesting** the buyer will use does not need to be stated in the purchase agreement.

However, escrow will include the exact wording of the vesting to be used by the buyer in the mutual instructions signed by both the seller and buyer.

The **vesting chosen** by the buyer is never a condition of the purchase agreement or escrow. The vesting on conveyance may be chosen (or unilaterally altered) by the buyer at any time prior to closing (but in sufficient time for preparation of the deed, signature by the sellers and acknowledgement by a notary prior to the date scheduled for closing).

Escrows prefer to draft the deed to be signed by the seller when escrow instructions are prepared. Thus, an early decision by the buyer about his vesting is necessary to accommodate the escrow process.

Hence, the buyer's agent needs to possess a working **knowledge of vestings** to be able to advise the buyer on the vestings available to the buyer so the agent is able to aid in the selection of the vesting desired before dictating instructions to escrow.

A person or persons take title

Real estate is owned by a *person* or *persons*, who by definition is either an **individual** (or individuals) or an **entity**, such as a corporation, limited liability company (LLC) or partnership. Trusts are not entities in California unless they have been qualified as a corporation by the Department of Corporations. Thus, the **beneficiary** of the trust relationship, be it an individual or an entity, is the *owner* of the real estate in spite of the vesting being in the name of a third person as trustee.

Further, **ownership** by an individual or entity is classified as either:

- a *sole ownership*, legally called an *ownership in severalty* [Calif. Civil Code §681]; or
- a *co-ownership* of two or more persons.

Sole ownership is reflected by use of a vesting naming an individual or entity as the one person entitled to ownership of the entire property described in the conveyance transferring title to that person. The **one person named** in this vesting context could be a married individual who owns property as the separate property of the married individual.

Co-ownerships exist for *individuals* in two fashions:

- as *vested co-owners* on title; or
- as *co-owners* of an **entity**, which is itself the vested owner holding title to the property.

Co-owners vest title in their individual names under one of only four types of ownership available for property located in California:

- as joint tenants;
- as tenants in partnership;
- as tenants in common; and
- as community property, with or without the right of survivorship. [CC §§682, 683]

No other co-ownership vesting exists for individuals. Thus, the **trust vestings** which exist provide for one person as *trustee* to hold title for the true owner(s) who are named as *beneficiary(ies)* under a title holding agreement the owner has entered into with the trustee. The trust agreement spells out ownership arrangements which are either the same as one of the four co-ownership interests provided by the vestings listed above or distinguishable from them, such as a subordinated ownership interest, priority distributions, allocation of tax benefits, etc., typical of co-ownership arrangements for an entity.

Finally, **community property ownership** has two available vestings:

- husband and wife as community property; and
- husband and wife as community property with the right of survivorship.

The community property vestings are only available to married couples.

Possessory rights of co-owners

Each co-owner of property has the right to:

- **possess** the entire property himself, to the extent it is not already possessed or leased to others by another co-owner;
- **lease** his possessory right to occupy and use the entire property to a tenant, except for community property since the lease is subject to being set aside by a nonconsenting spouse within one year after its commencement;
- **sell** his ownership interest in the property without the need for prior notice to or the consent of the other co-owners, except for community property or a co-owner who has agreed to the contrary; and
- **encumber** his ownership interest in the property without the consent of his co-owners, except for community property or when prohibited by a co-ownership agreement.

On the other hand, a co-owner has obligations to other co-owners not to:

- **exclude other** co-owners from their right to possession of any part of the property [**Oberwise** v. **Poulos** (1932) 124 CA 247]; or
- **create an easement** on the property against a co-owner.

Tenancy in common

Should the type of vesting not be stated when two or more persons take title to real estate, the co-owners are presumed to be *tenants in common*, a sort of **default vesting** attributed to their ownership. However, if the co-owners are husband and wife and title is not vested as a tenancy in common, the property is presumed to be *community property*. Also, if the conduct of the co-owners is in fact that of partners, the property ownership is subject to the rights of a tenancy in partnership. [CC §686]

Thus, a tenancy-in-common vesting is the form of ownership used by two or more persons, with an **equal or disproportionate share** of ownership in the property as the separate property of each, when they do not intend their relationship to be that of joint tenants on death or of partners for profit. Further, the property is not acquired as a community property asset. [CC §685]

If the fractional co-ownership interest held by each co-owner was transferred to them at the same time, by the same deed and in equal shares, e.g., 1/3, 1/3 and 1/3, on the recording of one deed, then the only distinction between vesting the co-ownership as a tenancy in common or a joint tenancy is the right of survivorship attached to the joint tenancy vesting.

Thus, the person vested as a tenant in common **retains control** over the destiny of his ownership interest on death. The control is exercisable by will or by vesting the co-owner's interest in the name of his inter vivos trust. The survivors in an ownership arrangement vested as tenants in common will not take the deceased's interest as would have occurred on their death under a joint tenancy vesting.

As tenants in common, co-owners retain the ability on death to transfer their interests in real estate to individuals other than the remaining co-owners of the property. Children jointly taking property on the death of a parent or relative will typically be designated as tenants in common or automatically be classified as tenants in common for failure of the will or trust agreement to state the nature of their co-ownership.

Tenancy in partnership

Groups of investors numbering just a few individuals often acquire property as co-owners, to hold and operate as income-producing property. They often take title to the real estate as **tenants in common**. However, the venture necessitates a joint effort for the **collective benefit** of all the individual co-owners. Thus, a *tenancy in partnership* exists for ownership purposes and a California partnership has been formed for operating purposes. [CC §682(2); Calif. Corporations Code §§16202(a), 16204(c)]

The group, as co-owners of property which requires day-to-day management, jointly operate a business venture. The management is conducted either directly by one or more of the co-owners in a coordinated effort or indirectly through a property manager. However, to be common-law tenants in common, the co-owners must intend not to act as a group, an issue for avoiding tax partnership treatment.

Property vested in the names of **profit-sharing, co-venturing co-owners** as tenants in common is property owned by their "partnership," not property fractionally owned and separately managed and operated by each co-owner individually. [Corp C §16203]

Thus, even though title is vested in all the individual co-owners as tenants in common, each co-owner actually holds title as a *trustee* on behalf of their **informal partnership** since the property's operation requires a coordinated or **centralized-management** effort. [Corp C §16404(b)(1)]

Nature of a joint tenancy

Although most **joint tenancies are created** between a husband and wife, a joint tenancy can be created between persons other than a married couple, such as between other family members. In contrast, the community property vestings, of which there are two, are only available to a married couple.

Also, the number of joint tenants holding title is not limited to two, as is the case for a married couple's ownership of community property. Any number of co-owners can, under one deed, take title to real estate as joint tenants so long as they **share equally in ownership**.

The joint tenancy vesting has been and is an estate planning tool used for the orderly transfer of ownership between family members on death. The vesting is rarely used in a business environment, except for community-owned enterprises or investments.

Traditionally, the creation of a joint tenancy requires the conveyance of *four unities*:

- *unity of title*, meaning the joint tenants take title to the real estate through the **same instrument**, such as a grant deed;
- *unity of time*, meaning the joint tenants receive their interest in title at the **same time**;
- *unity of interest*, meaning the joint tenants own **equal shares** in the ownership of the property; and
- *unity of possession*, meaning each joint tenant has the **right to possess** the entire property.

Today, a joint tenancy is loosely based on these four unities. For example, a joint tenancy is defined as ownership by two or more persons in **equal shares**. Thus, the joint tenancy co-ownership incorporates the unity of interest into the statutory definition. [CC §683]

Similarly, a joint tenancy must be created by a **single transfer** to all those who are to become joint tenants. Thus, the historic unity of title (same deed) and unity of time (simultaneous transfers) required under common law have been retained in one event, typically being the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being **a single conveyance** to all joint tenants, if the conveyance states the co-owners take title “as joint tenants”:

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to himself and others;
- a transfer from co-owners vested as tenants in common to themselves; or
- a transfer from a husband and wife holding title as community property, tenants in common or separately, to themselves. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or lifelong friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional interest** in ownership. Their actual fractional ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants.

Joint tenant’s right of survivorship

The sole advantage of a joint tenancy vesting for co-owners is the *extinguishment* of a co-owner’s entire co-ownership interest in the property on his death. **On death**, the interest of the deceased co-owner is absorbed by the surviving joint tenant(s). Thus, the ownership interest previously held by the deceased co-owner avoids probate procedures since no interest remains to be transferred.

The same results occurs on death if a married couple uses the community property with right of survivorship vesting to hold title to real estate or personal property.

Other than the *right of survivorship*, a joint tenancy vesting neither adds nor diminishes the legal or tax aspects of the ownership interest held in the real estate by each co-owner.

For example, whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest, until death.

Thus, the right of survivorship is the distinguishing feature of a joint tenancy vesting and is legally referred to a *jus accrescendi*. The right of survivorship is a doctrine developed by case law and now codified in California.

The right of survivorship only becomes operative at the **time of the death** of a joint tenant. On death, the right of survivorship extinguishes the deceased’s interest and leaves the **remaining joint tenant(s)** with the entire ownership of the property to *share equally* among the surviving joint tenants.

Ultimately, on the death of all other joint tenants, the last surviving joint tenant becomes the sole owner of the property originally owned by all the joint tenants.

The mesh of ownership rights

Joint tenancy rights and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California legal history.

Joint tenancy, with its inherent right of survivorship, arises out of the English common law, and is called a *common law estate*.

Community property, with its implicit partnership aspect, is a creation of Spanish civil law, dating from the time California was a Spanish colony.

Older cases treated community property and joint tenancy as mutually exclusive, i.e., holding real estate as community property meant it could not be held in a joint tenancy vesting and retain its community property status. Thus, a *transmutation* from community property to the separate property of each the husband and wife occurred by a transfer into a joint tenancy, comparable to vesting community property in a tenancy in common vesting today. [**Tomaier** v. **Tomaier** (1944) 23 C2d 754]

However, this "mutually exclusive" rule, which controlled legal results by the type of vesting and not by the community nature of the ownership between husband and wife, was eliminated in 1975.

Today, a joint tenancy vesting is merely a vesting used by co-owners solely **to avoid probate**. The joint tenancy vesting provides no other advantage to the co-owners. The underlying community or separate property character of the real estate is not affected when a husband and wife vest their co-ownership as joint tenants.

For instance, a husband and wife who take title as joint tenants do not by the vesting *transmute* their community property into separate property owned 50:50 by the husband and wife.

However, a joint tenancy vesting allows a husband and wife to **renounce the community property presumption** should they claim they intended the joint tenancy vesting to establish separate property interests in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by the husband and wife to deter creditors. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result altering community property rights occurs in federal **bankruptcy** proceedings when a husband and wife hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt.

Thus, a spouse's one-half interest in community property vested as joint tenants is **not liable in bankruptcy** for debts which were incurred solely by the other spouse and not on behalf of the community. [**In re Pavich** (1996) 191 BR 838]

Unless the couple intends by the joint tenancy vesting to transmute their community property into separate property when they take title to their community assets as joint tenants, the property is **presumed** to be a community asset without concern for the joint tenancy vesting.

Conveying community property

Both spouses must consent to the sale, lease for more than one year, or encumbrance of the community real estate no matter how it is vested. [Calif. Family Code §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set the transaction aside.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known. [Fam C §1102]

Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber his interest in the real estate depends on whether the real estate interest vested in the individual is his *separate property* or the *community property* of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year. [Fam C §1102]

Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is *voidable* since the transaction may be set aside by the **nonconsenting spouse** if acted upon within one year after commencement.

Further, a purchase agreement for the sale of community property entered into by only one spouse may not be enforced in any part by the buyer through an action for specific performance.

Thus, a purchase agreement entered into by one spouse to sell only his one-half interest in the community property is unenforceable unless consented to by the other spouse. Community property **may not be conveyed**, leased or encumbered without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

However, if **record title** to the community real estate is in the name of **one spouse only**, a sale, lease or encumbrance executed solely by the title-holding spouse is presumed valid if the buyer, tenant or lienholder has no actual or constructive knowledge of the marriage. This includes any knowledge of the agent representing the buyer, landlord or lender, about the owner's marital status. [Fam C §1102(c)]

Separate property joint tenancy vestings

When real estate held in a joint tenancy vesting is the **separate property** of each joint tenant, such as three siblings or a parent and child, each joint tenant can sell or encumber his interest in the real estate **without the consent** of the other joint tenants.

Also, when the real estate owned by a joint tenant is his separate property, the joint tenant may **lease** out the entire property since a lease is a transfer of possession, and each joint tenant has the *right to possession* of the entire property.

However, consider a husband and wife who own real estate which is **community property**. They hold title as joint tenants. The husband enters into an agreement to lease the property to a tenant for a term of over one year. The wife does not enter into the lease agreement with the tenant.

Under joint tenancy rules, any joint tenant acting alone may lease the entire property to a tenant. However, under community property rules (which apply to property acquired during the marriage with community assets), both spouses must execute a long-term lease agreement for the tenant to avoid challenges to set aside the lease for failure of both the husband and wife to sign the lease.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay and **superiority of community property rights** when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting should be viewed as controlling the landlord-tenant relationship. Thus, the joint-tenant husband or wife indivdually is allowed to lease the property.

Also, the *doctrine of ratification* would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease before attempting to set the lease aside. [CC §2310]

The agent's role and listings

A broker and his agents who represent a married person in the sale, lease or financing of community real estate must know whether the performance by the married person of a promise to pay a fee under a listing or to close escrow on a purchase agreement can be legally avoided by asserting **community property defenses**, thereby inflicting a loss on the broker.

For example, a broker obtains an exclusive right-to-sell listing signed only by the wife. The real estate listed is vested in the name of the husband and wife either as community property or as joint tenants.

During the listing period, the couple acting independent of the broker sell the property without the payment of a fee to the listing broker. The listing entitles the broker to a fee, payable by the person who signed the listing, if the property is sold by anyone during the listing period. [See **first tuesday** Form 102]

The broker claims both the husband and wife are liable for the brokerage fee since the actions of the wife committed the community to the payment of a fee and the property was sold during the listing period.

The wife claims the listing is unenforceable without the husband's signature since no part of the property listed can be sold and conveyed without her husband's written consent.

Is the broker entitled to his fee?

Yes! The wife, separate from the husband, is liable for the fee since she signed the listing agreement **employing the broker**. The broker can enforce collection of his fee due under the listing in an action for money against the wife. However, the husband, who did not sign the listing agreement, is not personally liable for the brokerage fee. [**Tamimi** v. **Bettencourt** (1966) 243 CA2d 377]

Further, on recording the broker's abstract of the judgment against the wife for the brokerage fee, the judgment becomes a **lien on all community** real estate owned by the couple. The husband's **separate property**, however, is not liened and remains unaffected by the abstract which attaches as a lien to both the wife's separate property and their community property.

In contrast to a listing employing a broker to locate a buyer, an action for specific performance by a buyer to enforce a real estate purchase agreement signed only by the wife will not be successful. An **agreement to sell** community real estate requires both spouses' signatures. *Management and control* is in both, not just one co-owner, when the property is community real estate, no matter how vested.

Severing a right of survivorship

A husband and wife are the vested owners of a parcel of real estate which is community property. The vesting provides for the right of survivorship under either a community property with right of survivorship vesting or a joint tenancy vesting.

However, every co-owner vested as a joint tenant or community property with right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner *terminates* the right of survivorship in that co-owner's interest, whether his interest in the real estate is separate or community property. The separate or community property **nature of the co-owner's interest** in the property remains the same after severing the right of survivorship from the co-owner's interest.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

AFFIDAVIT OF DEATH OF JOINT TENANT

DATE: ____________, 20_____, at ____, California.

____,
is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of ________________________, California, referred to as:

APN# __________________

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: ____________, 20_____ ____
(Print Name) (Signature)

Date: ____________, 20_____ ____
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF ____
SUBSCRIBED and SWORN to (or affirmed) before me on this ________________________ day of ____________, 20_____,
by ____,
proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

____
(Seal)

____
(Signature)

(This area for official notarial sel)

A co-owner terminating the right of survivorship in his interest is not required to first **give notice** or seek consent from the other co-owner(s). [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

To *sever* the vesting, the co-owner prepares and signs a deed from himself "as a joint tenant" or "as community property with right of survivorship," back to himself. On recording the deed, the right of survivorship is severed by having merely *revested* the co-owner's interest. The deed revesting title should include a statement noting that the transfer is intended to sever the prior vesting. [CC §683.2(a)]

Alternatively, the co-owner could transfer title to himself as trustee under the co-owner's revocable inter vivos (living) trust agreement. The conveyance into **the trust vesting** would also sever the right of survivorship. By the conveyance, the trust vesting would also avoid the probate process while gaining **control over succession** of the co-owner's interest on death. Again, community property remains community property even though vested in the living trust of the individual husband or wife.

Further, any transfer of a joint tenant's interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, **automatically severs** the joint tenancy.

Termination of interest on death

Again, when the co-ownership of property is vested as joint tenants or community property with right of survivorship, the death of a co-owner *automatically extinguishes* the deceased co-owner's interest in the real estate. Thus, the surviving co-owner(s) becomes the sole owner(s) of the property.

However, **title** to the deceased co-owner's interest in the property must be cleared away before the surviving co-owner(s) will be able to properly sell, lease or encumber the property as the owner(s).

The enlarged ownership interest of a surviving joint tenant, clear of the deceased's interest, is documented by simply recording an *affidavit*, signed by anyone, declaring the death of a joint tenant who was a co-owner and describing the real estate. [See Form 460 accompanying this chapter; Calif. Probate Code §210(a)]

Likewise, the half interest in **community property** held by the deceased spouse at the time of death vested "as community property with right of survivorship" is *extinguished* by the same affidavit procedure used to eliminate the interest of a joint tenant. However, the surviving spouse (or the surviving spouse's representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

Judgment against a spouse

Now consider a husband who encumbers community property with a trust deed, executed by the husband alone and without the consent of the wife. The trust deed secures a note which evidences a debt or other monetary obligation undertaken by the husband.

Later, the trust deed lien is set aside in a judicial action by the wife since the wife did not consent to the encumbrance of the community property.

The husband defaults on the now unsecured loan. The lender obtains a money judgment against the husband individually and records an abstract of the judgment **naming only the husband** as the judgment debtor.

On **recording the abstract**, the judgment debt attaches as a lien to all community property in which the husband presently has an interest, as well as the husband's separate property interests in other real estate. The wife's separate property is unaffected by the recorded abstract.

Now, the same community property which had been previously encumbered by the judicially voided trust deed lien is now encumbered by the judgment which attached as a lien by recording the abstract.

Later, the couple's marriage is dissolved and the wife is awarded sole ownership of the community property, now her separate property.

The wife claims the money judgment lien did not attach to the property since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

Here, the recording of the abstract of judgment against the husband created a **valid lien** on all community property owned by the couple, including the property which later became property solely owned by the wife. The judgment against the husband attached to the property while it was still community property, before a property settlement conveyed the property or the marriage had been dissolved. [**Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56]

Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife when the surviving spouse becomes the sole owner of what was community property at the time of death, no matter how vested by them, is: What is the surviving spouse's **cost basis** in the property as the sole owner on the death of the spouse?

The surviving spouse who becomes the sole owner of community real estate on the death of a spouse receives a "fully" **stepped-up cost basis** to the property's *fair market value* on the date of the death which terminated the community.

Thus, the surviving spouse is entitled to a fully stepped-up basis in real estate previously owned by the community without concern for whether the **community property** was vested as community property, as joint tenants or in a revocable inter vivos trust. State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with "... the form in which title is taken" to community property. [IRS Revenue Ruling 87-98]

By California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is acquired, managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate owned by a husband and wife (unless vested as tenants in common) is community property for federal income tax purposes. Accordingly, the surviving spouse on receiving the property receives a cost basis stepped-up to the property's **fair market value** on the date of death, the result of becoming the sole owner of property previously owned by the community.

Chapter 33 Preliminary title reports

This chapter addresses the use of a preliminary title report by a buyer to review the condition of title to eliminate contingency provisions, and by escrow to prepare closing documents.

An offer to issue title insurance

An investor enters into an agreement to purchase real estate from a financially distressed seller.

Closing of the transaction is contingent on the investor's receipt and review of a preliminary title report (prelim) to confirm the property is subject only to the loans and other liens disclosed by the seller. Any taxes or monetary liens of record which are not disclosed in the purchase agreement are to remain of record. However, the amount of any undisclosed lien will be deducted from the cash down payment.

Escrow is opened with instructions to order a prelim from a title insurance company for approval of the condition of title by the investor. To keep acquisition costs to a minimum, escrow is instructed to close without obtaining a policy of title insurance.

The prelim received by escrow indicates the title is clear of all encumbrances, except those disclosed by the seller. Believing the title condition is as represented by the seller, the investor waives the further-approval contingency regarding approval of the prelim.

Escrow closes on receiving a "date-down" on the prelim from the title company — without the issuance of a policy of title insurance.

However, the preliminary title report failed to disclose a recorded abstract of judgment against the seller which had attached to his title as a judgment lien. Later, the judgment creditor enforces the judgment lien by commencing a foreclosure on the property.

The investor clears title of the lien and makes a demand on the title company for the amount of the payoff since they prepared an erroneous prelim. The investor claims the title company is liable for his losses since it failed to disclose the judgment lien on the preliminary title report, a misrepresentation of title.

Can a buyer, escrow officer, broker or agent rely on a prelim as assurance the title condition is "as represented" in the preliminary title report?

No! A preliminary title report is not a representation of the condition of title or a policy of title insurance. Unlike an *abstract of title*, a prelim cannot be relied on by anyone.

A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (shown as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report is no more than an **offer to issue** a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued. [Calif. Insurance Code §12340.11]

Use of the prelim

A preliminary title report typically discloses the current vesting, as well as the general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, encumbrances, liens and any interests of others which may be reflected on the public record as affecting title, collectively called *encumbrances*.

The closing of many purchase escrows is conditioned on the buyer's approval of the prelim. The buyer, his agent and escrow review the report on its receipt for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title in the purchase agreement and escrow instructions.

Buyer's agents in a sales transaction check the prelim prior to closing for title conditions. Buyers' agents are looking for title conditions which might interfere with any **intended use or change in the use** of the property contemplated by the buyer. Interferences could be in the form of unusual easements or use restrictions which obstruct the buyer's announced plans to make improvements.

Finally, escrow relies on the prelim to carry out its instructions to record grant and trust deeds, leaseholds, or options which will be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances specified in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim and a last-minute *date-down* of title conditions are used by escrow to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded (deeds, trust deeds, etc.).

Should the date-down of the prelim reveal defects or liens not previously reported in the prelim, either by error or by later recording, the title company can **withdraw its offer** under the prelim and issue a new prelim, an offer to issue a policy on different terms.

Prelim vs. abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts which held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate liability for their preparation of faulty preliminary title reports.

Prelims were once compared to abstracts of title. An **abstract of title** is a written statement which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on liability set by the policy. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from a failure to properly prepare the abstract. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a repre-

sentation of the condition of title. The prelim is now defined as a report furnished in connection with **an application** for title insurance. [Ins C §12340.11]

The prelim has become and is simply an **offer** by a title company to issue title insurance. The prelim is merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to last minute changes prior to issuing the policy of title insurance.

Chapter 34 — The counteroffer environment

This chapter examines the seller's response to an unacceptable purchase offer by countering with an offer which consists of terms different from the terms of the purchase offer being rejected.

Meeting the seller's objectives

The preparation of a counteroffer is an occasion when a listing agent and seller have an opportunity to take control of negotiations which a prospective buyer has commenced by the submission of a written purchase agreement offer. For the listing agent, the **counteroffer** is his moment:

- *to care for and protect* the seller by addressing property disclosures to be made by the seller to perfect any agreement the seller may enter into with the prospective buyer; and
- *to clarify* any uncertainties about the buyer's ability to close escrow.

Essentially, a counteroffer allows the listing agent to actually eliminate contingencies regarding disclosures which serve only to cancel or reprice the sale for the seller. At the same time, the listing agent can take steps to establish the buyer's qualifications for any purchase-assist financing and the source of any other funds needed by the buyer to close the transaction.

The environment surrounding the listing agent's analysis of the buyer's offer and the agent's later review of the offer with the seller is nearly always within the control of the listing agent, as it should be.

A prompt, initial review of the offer by the listing agent, alone and before advising the seller it has been received, is necessary to prepare the agent to handle his call to the seller to set an appointment for a review of the buyer's offer.

On hearing the listing agent has received an offer, the seller's first comments generally tend to focus on the price, transactional costs, the buyer's ability to close escrow and when the seller will be handed the net sales proceeds.

Conversely, the listing agent is primarily concerned with:

- the seller's obligation to the prospective buyer to disclose his knowledge about the property which, if disclosed after entering into a purchase agreement contract, may well affect the price the buyer may then be willing to pay for the property, lead to the buyer's cancellation of the purchase agreement, or reduce the seller's net proceeds should the seller have to eliminate undisclosed conditions exposed by a late disclosure which are unacceptable to the buyer; and
- the agent's preparation for his appointment with the seller which will cover information needed to be reviewed by the seller before a decision can be made to accept or reject (by a counteroffer) the buyer's purchase agreement offer.

The diligent listing agent

A **listing agent's duty** owed to his seller on the submission and review of a prospective buyer's offer includes:

- advice on the *seller's obligations* to disclose property conditions and obtain clearances or eliminate defects triggered by the buyer's due diligence investigation;
- a review of the agent's concerns about the acceptability or modification of *contingency provisions* which affect closing;
- disclosure of the likely *net sales proceeds* the offer will generate; and
- if the property is other than the seller's personal residence, the agent's knowledge about the profit *tax liability* the seller will most likely incur on the sale.

For example, an agent representing a prospective buyer submits a purchase agreement offer without first obtaining a copy of the listing agent's marketing package on the property. The package contains all the required seller disclosures the seller and listing agent are required to deliver to prospective buyers.

Thus, the buyer does not take into consideration the adverse property conditions **disclosed** in the marketing package when the buyer made his decision about the price and terms on which he is willing to buy the property. However, the buyer will discover these conditions when the disclosures are eventually handed over.

Accordingly, the listing agent's advice to the seller on submitting and reviewing the offer is to counter the offer and include as addenda all the required disclosures. The disclosures, at the agent's insistence when listing the property, have already been prepared and are available for the prospective buyer to approve before entering into a purchase agreement.

Thus, the pre-contract disclosures will eliminate most of the contingencies which affect the price, the amount of the seller's transactional expenses and the buyer's ability to cancel the purchase agreement, all of which concern the listing agent.

By a thoughtful analysis of the buyer's offer prior to meeting with the seller, the listing agent prepares himself to advise the seller on the use of a counteroffer to best respond to the offer. Thus, the agent seeks to reduce the uncertainties about the consequences of an unmodified acceptance of an offer.

Various responses to an offer

Several procedures exist for a seller to respond to an unacceptable offer, especially an offer which, with a few minor changes, would be acceptable to the seller. However, minor changes regarding the selection of the escrow company, the deadline for loan approval, verification of downpayment funds, or the sale or purchase of other property constitute a counteroffer.

The listing agent handling negotiations for a change in the terms of the buyer's purchase offer should reduce the seller's (counter)offer to a writing signed by the seller before it is submitted to the buyer. The seller's signed counteroffer manifests his intent to be bound by his offer to sell, if the buyer accepts.

The seller's counter to an unacceptable purchase agreement offer can be written up by the listing agent and submitted to the buyer using any one of the following formats:

1. Prepare the seller's offer on a **new purchase agreement form**, possibly on a different and more appropriate form for the transaction than the form used by the buyer's agent. No reference is made in the seller's new offer to the rejected purchase agreement offer previously submitted by the buyer. This new original offer prepared by the listing agent will be signed first by the seller and listing agent, then submitted to the buyer for the buyer's acceptance or rejection.
2. Prepare the seller's offer on a **counteroffer form** which includes, by reference, all the terms and conditions of the buyer's offer. Modifications are then entered on the counteroffer form stating the

COUNTEROFFER

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is a counteroffer to an offer entitled:

☐ Purchase agreement
☐ Exchange agreement
☐ Counteroffer
☐ ____________________________________

1.1 dated _____________, 20______, at ____, California,
1.2 entered into by ____, as the _________________________,
1.3 regarding real estate referred to as ____,
____.

AGREEMENT:

2. The undersigned includes all the terms and conditions of the above referenced offer in this Counteroffer, **subject to** the following modifications:

____
____
____
____
____
____
____
____
____
____

3. This Counteroffer will be deemed revoked unless accepted in writing and delivered to the undersigned or their broker prior to the time of ________________ on _____________, 20______.

Buyer's Broker: _________________________________
By: ____

Seller's Broker: _________________________________
By: ____

I agree to purchase this property as stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______
Buyer's Name: _________________________________
Signature: ____________________________________
Buyer's Name: _________________________________
Signature: ____________________________________
Address: _____________________________________
____
Phone: ___________________ Fax: ________________
Email: _______________________________________

I agree to sell this property as stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______
Seller's Name: _________________________________
Signature: ____________________________________
Seller's Name: _________________________________
Signature: ____________________________________
Address: _____________________________________
____
Phone: ___________________ Fax: ________________
Email: _______________________________________

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terms and conditions sought by the seller which are different from those in the buyer's offer which are unacceptable to the seller. [See Form 180 accompanying this chapter]

3. Dictate **escrow instructions** based on an agreement orally negotiated with the buyer (or buyer's agent) to resolve the seller's dissatisfaction regarding the terms and conditions in the buyer's offer. The instructions are submitted to the seller and buyer for signatures. On receipt by escrow of copies of the instructions containing the signatures of all parties, the escrow instructions then become the only agreement entered into by both the buyer and seller. Here, the escrow company becomes a sort of secretarial service used by agents who do not take the time to prepare a written counteroffer themselves.
4. **Alter the original written offer** the buyer has already signed by deleting unacceptable provisions from the face of the document and entering the differing provisions sought by the seller, a process called *deface and interlineate*. The altered purchase agreement is then signed by the seller in the acceptance provision and returned to the buyer as the seller's counteroffer. This counteroffer and acceptance procedure is called *change and initial*, and is used when a counteroffer form is not made available and prepared by the listing agent.
5. Set up an **auction environment** (if the current market is composed of too many buyers for too little inventory) by calling for the submission of all offers on a date and at a time set for the seller to accept the best offer of all those presented by prospective buyers, or by creating some other auction situation short of the seller signing multiple counteroffers, an awkward (and typically misguided) response to the receipt of multiple purchase offers.
6. **Orally advise** the buyer's agent about the changes required before the buyer's offer will be acceptable to the seller. If the buyer is interested in the property based on those changes, the buyer's agent is asked to prepare and submit a new purchase agreement offer signed by the buyer for the seller to consider. This situation requires the buyer to "negotiate with himself," while the seller remains uncommitted to sell on any terms. Here, either the listing agent does not take the time to prepare a counteroffer stating the terms and conditions on which the seller will sell or the seller wants to remain uncommitted.
7. Let the **offer expire**, then resume negotiations with the buyer and his agent if the buyer still has an interest in the property.

The counter is an offer

The rules for preparing and submitting a counteroffer and those for accepting a counteroffer to buy and sell real estate are the same rules applied to determine whether an offer made by a seller has been submitted to the buyer or an acceptance by the buyer has occurred to form a binding contract.

Real estate agents instinctively consider submitting written offers from a buyer to a seller to comply with the rule requiring a written agreement, signed by the buyer and seller to form a real estate contract. Likewise, they should automatically submit written counteroffers from sellers to buyers when the seller will not accept the buyer's offer.

For example, on the buyer's receipt of a seller's counteroffer, the buyer may be unwilling to accept the terms stated, but be willing to submit an offer on different terms. In essence, a counter to the counter. The buyer's agent also uses a counteroffer form to prepare the buyer's new offer.

The buyer's counteroffer, by reference, includes all the terms and conditions of the seller's counteroffer (which itself may reference and include all the provisions in the buyer's original offer). These referenced terms are then modified by entry on the counteroffer form of terms and conditions contrary to those sought by the seller.

Alternatively, the buyer's agent could draft an entirely fresh purchase agreement offer setting forth the terms agreeable to the buyer.

Forms for entering into agreements usually are flexibly worded for the signatories to merely reflect, "I agree to the terms stated above." The wording eliminates concern about whether the buyer or seller must first sign the document to make an offer or counteroffer.

Defacing a signed document

Listing agents sometime delete terms or provisions in a signed purchase agreement they have received by lining them out with a pen or covering them with white-out, called *defacing*. The agent then adds copy to the document to replace the deleted material, called *interlineation*.

The seller then signs the altered document agreeing to the terms of the offer as modified, a counteroffer technique called *change and initial*. However, it is improper conduct for anyone to in any way alter the contents of an original document once it has been signed.

Consider the plight of a buyer's agent who is industriously working to locate unimproved land for a client. He contacts the owners of several suitable properties by mail, soliciting information as to whether they will consider selling their property. One absentee owner who responds indicates he would entertain an offer from the agent's buyer.

The agent prepares an offer which his buyer signs, agreeing to purchase the land on an installment sale arrangement payable over a ten-year period. The signed purchase agreement is sent to the absentee seller. On receipt, the seller calls the buyer's agent to discuss some changes he wants by way of an increase in price and an earlier payoff. The terms discussed are acceptable to the buyer.

The buyer's agent prepares another purchase agreement offer reflecting the changes sought by the seller, which the buyer signs as a fresh, new offer. The offer is sent to the seller. On his receipt, the seller calls the buyer directly. They orally negotiate a cash price payable in 20 days.

To write up the new terms, the seller makes extensive changes to the buyer's second purchase agreement offer by **striking out** the price, terms of payment, closing date, title changes, due diligence investigation contingency provision, etc. On the face of the document, the seller then enters the terms and conditions which replace the strickened ones.

The seller signs the purchase agreement indicating he "agrees to all the terms stated" and returns it to the agent. The changes correctly reflect the changes the buyer agreed to by phone. To accept the modified purchase agreement, the buyer then **initials** all the significant changes made by the seller, but does not initial every minute and minor entry made by the seller. No changes or additions to the document are made by the buyer. The buyer does not re-sign the original purchase agreement in addition to his initializing the changes.

The purchase agreement with the buyer's initials throughout is returned to the seller, who receives it. The agent dictates escrow instructions which are prepared reflecting the final terms as agreed to in the changed-and-initialed counteroffer. The buyer signs and returns his copy of the instructions; the seller does not.

The agent calls the seller asking him to sign and return the escrow instructions and the deed. The seller says they have no deal since the buyer did not initial each and every entry made by the seller on the purchase agreement. The seller claims the failure to initial each minute change he made was a *qualified acceptance* which did not form a binding agreement.

Here, the seller and buyer did enter into a binding and enforceable purchase agreement. The **essential terms** needed as a minimum to provide the certainty and clarity required to establish an enforceable real estate purchase agreement between them existed and were initialled.

Further, and significantly, the buyer did not make any changes or add any wording to the offer. By returning the initialed and unaltered counteroffer, the buyer indicated he intended to accept of the seller's (counter)offer as submitted by the seller.

Also, the failure to initial minor and nonessential provisions was inadvertent and not necessary to determine the performance required of the seller to deliver a deed in exchange for cash. [**Kahn** v. **Lischner** (1954) 128 CA2d 480]

In retrospect, had the buyer's agent been directly involved in the final counter-proposal made by the seller, he would have prepared yet another new original purchase agreement offer. It would have been signed by the buyer and sent to the seller to sign and return.

However, the seller did commit himself in his counteroffer to sell on terms which were certain. The buyer should have again signed his name at the end of the agreement and dated it to demonstrate he "agreed to the terms stated above," which on signing would have included all the changes made by the seller on the face of the document.

Had the seller been represented by an agent, his agent properly would have prepared the counteroffer on either a counteroffer form or a new purchase agreement form for the seller to sign. The prepared form would have contained those terms the seller entered by interlineation into the buyer's original purchase agreement offer.

Then, the buyer's acceptance of the counter would have been simple. He would agree to buy on the terms stated in the seller's counteroffer by simply signing the seller's (counter)offer and delivering the counteroffer with the signed acceptance.

Chapter 35 Income property acquisitions

This chapter distinguishes the purchase agreement used for acquiring income property from purchase agreements used for other purposes and reviews its use as a checklist for due diligence investigations.

Investigating a property's worth

At an investment property marketing session, an agent looking for properties to acquire on behalf of his client picks up a mini-package on a property listed for sale by another agent. The package contains an Annual Property Operating Data (APOD) sheet. On review of the APOD, the property appears to match the income property requirements of his client.

The client is contacted. Both the agent and the client drive by the property. The building's exterior appearance is acceptable. The area surrounding the property looks stable. The property seems properly located for a project of its size and type. It is agreed the agent will gather more information on the property.

The agent obtains a profile on the property from a title company. The title is consistent with information received from the listing agent regarding trust deeds and vesting.

To begin an analysis of the property, the agent contacts the listing agent for more **fundamentals** on the property, asking him to produce:

- a **rent roll** spread sheet covering each unit (type, size, tenant, commencement of occupancy, expiration of lease, rent amount and any discount/free rent, payment history, furnishings, etc.);
- a two-year **occupancy history** on each unit;
- information regarding **security arrangements** and criminal activity on or around the property during the past year;
- a **property manager** or resident manager who is available for an interview;
- information regarding **maintenance procedures** and the repair services used;
- a copy of schedule "B" (CC&R exclusions) to the owner's policy of **title insurance**;
- the lender's name and the balance, payments, interest rates and due date on each **existing loan**; and
- any available information relating to the integrity of the **property's condition** and the nature of the property's location which might adversely affect the property's value.

The prospective buyer's agent asks for all this information knowing the seller and the listing agent **owe a duty to inform** all prospective buyers and their agents of all facts about the property that are *known or readily available* to them which might have an adverse impact on its market value. Hopefully, the listing agent has already gathered all the fundamental property information and has it ready in a complete listing or marketing package.

If the listing agent has not yet gathered the facts which are available to him, he will likely insist the information is not necessary for a prospective buyer to submit an offer. However, price negotiations should not commence until disclosures of **all readily available** property data and information have been handed over by the seller or his listing agent since the confirmation of the **veracity of these disclosures** is what due diligence investigations prior to closing are all about.

The prospective buyer is advised the seller or the seller's agent may insist he enter into a **confidentiality agreement** before some of the information requested of the seller's agent will be released. Thus, the buyer may need to identify himself to the seller before the seller will release information on the tenants, their leases and property operations, which the buyer needs to determine the property's worth and set the price and terms, before making an offer.

When the information is received and reviewed, if it warrants a further investigation into the suitability of the property for acquisition, the buyer's agent and prospective buyer will then personally inspect the premises and any vacant units, and thoroughly discuss operations with those who manage the property.

After receiving these initial disclosures and conducting a minimal investigation, the buyer's agent will prepare a purchase agreement if the property still appears to be suitable to the prospective buyer. By submission of the purchase agreement offer, they will **commence negotiations** on the price to be paid and the conditions which must be met so the prospective buyer can complete a due diligence investigation to confirm his initial expectations about the property. Any counteroffer by the seller will sort out the seller's willingness to permit the prospective buyer to corroborate the property's worth.

Analyzing the income property purchase agreement

The income property purchase agreement, **first tuesday** Form 159, is used to prepare and submit the buyer's **written offer** to purchase income property, excluding one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carryback note. Form 159 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate. [See Form 159 accompanying this chapter]

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 159 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Each section in Form 159 has a separate purpose and need for enforcement. The sections include:

1. *Identification*: The date of preparation for referencing the agreement, the name of the buyer, the amount of the good-faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.
2. *Price and terms*: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of existing financing are set forth in sections 3 through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.
3. *Acceptance and performance*: Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided for in section 10, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.

4. *Due diligence contingencies*: Contingencies for the buyer's due diligence investigations into income and expense records, rental income statements, hazard disclosures, property condition disclosures, and other relevant information to be delivered by the seller are set forth in section 11.
5. *Property Conditions*: The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is **confirmed** as set forth in section 12 by the seller's delivery of reports, warranty policies and certifications not handed to the buyer prior to entry into the purchase agreement.
6. *Closing conditions*: The escrow holder, escrow instruction arrangements and the date of closing are established in section 13, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.
7. *Brokerage and agency*: The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 15, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.
8. *Signatures*: The seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

Preparing the income property purchase agreement

The following instructions are for the preparation and use of the Income Property Purchase Agreement, **first tuesday** Form 159. Form 159 is designed as a checklist of practical provisions so a broker or his agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, other than one-to-four unit, income property located in California.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

Facts:

1. *Buyer, deposit and property*: **Enter** the name of each buyer who will sign the offer.

1.1 **Enter** the dollar amount of any good-faith, earnest money deposit. **Check** the appropriate box to indicate the form of the good-faith deposit. **Enter** the name of the payee (escrow, title company or broker).

1.2-1.3 **Enter** the name of the city and county in which the property is located.

1.4 **Enter** the legal description or common address of the property, or the assessor's parcel number (APN).

1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer must be listed as inventory if they are to be acquired by the buyer. [See **first tuesday** Form 256]

PURCHASE AGREEMENT

Income Property other than One-to-Four Residential Units

DATE: ____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from ____, as the Buyer(s),

1.1 the sum of $_______________, evidenced by ☐ personal check, or ☐ ____________________________, payable to ____, for deposit only on acceptance of this offer.

1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property

1.3 situated in the City of ________________________, County of ____________________, California,

1.4 referred to as ____,

1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this four-page form and ______ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . $_______________

3.1 Other consideration paid through escrow _________________________________ . . . . $_______________

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $________________ monthly for a period of ______ years.
Interest on closing not to exceed ______%, ☐ ARM, type ________________________.
Loan points not to exceed _____________.

4.1 ☐ Unless Buyer, within ______ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly, including interest not exceeding _____%, ☐ ARM, type __________________________, plus a monthly tax/insurance impound payment of $______________. ____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____ with an unpaid principal balance of . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%, ☐ ARM, type ______________________________, due _____________, 20 ______.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . $_______________

8. Note for the balance of the purchase price in the amount of. . . . . $_______________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _______________ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________.

8.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. **Total Purchase Price is** . . . . $_______________

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10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within ______ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ____.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $____________, or ☐ the deposit receipted in Section 1.

11. DUE DILIGENCE CONTINGENCIES:

Within ______ days after receipt or occurrence of any of the following conditions, Buyer may terminate the agreement based on Buyer's reasonable disapproval of the condition.

11.1 Income and expense records, leases, property management and other service contracts, permits or licenses affecting the operation of the property which Seller will make available to Buyer on acceptance.

11.2 Rental Income Rent Roll Statement itemizing, by unit, the tenant's name, rent amount, rent due date and delinquencies, deposits, rental period and expiration, and any rental incentives, bonuses or discounts signed by Seller and handed to Buyer on acceptance. [See **ft** Form 380]

11.3 Seller's Natural Hazard Disclosure Statement to be signed by Seller and handed to Buyer on acceptance. [See **ft** Form 314]

11.4 Condition of Commercial Property Disclosure — Commercial TDS to be signed by Seller and Seller's Broker and handed to Buyer on acceptance. [See **ft** Form 304-1] Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance.

11.5 Inspection of the property by Buyer, his agent or consultants within ______ days after acceptance for value and condition sufficient to justify the purchase price.

11.6 Preliminary title report for the policy of title insurance, which Seller will cause escrow to hand Buyer as soon as reasonably possible after acceptance.

11.7 An estoppel certificate executed by each tenant affirming the terms of their occupancy, which Seller will hand Buyer prior to seven days before closing. [See **ft** Form 598]

11.8 Criminal Activity and Security Disclosure Statement prepared by Seller setting forth recent criminal activity on or about the property relevant to the security of persons and their belongings on the property, and any security arrangements undertaken or which should be undertaken in response. [See **ft** Form 321]

11.9 ☐ See attached Due Diligence Contingencies Addendum for additional conditions. [See **ft** Form 279]

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer ____
Coverage ____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ ____

f. ☐ ____

12.2 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.3 Seller to maintain the property in good condition until possession is delivered.

12.4 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.5 New agreements and modifications of existing agreements to rent units, or to service, alter or equip the property, will not be entered into by Seller without Buyer's prior written consent, which will not be unreasonably withheld.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with ______________________________.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before ______________, 20______, or within ______ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

13.3 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title shall be insured by ______________________________ title company on a(n) ☐ CLTA standard, ☐ ATLA owner's, or ☐ ALTA binder, policy of title insurance.

a. Endorsements ______________________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.4 Buyer to furnish a new fire insurance policy covering the property.

13.5 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

a. ☐ Attached is a notice of your Supplemental Property Tax Bill. [See **ft** Form 317]

13.6 Bill of Sale to be executed for any personal property being acquired.

a. ☐ A UCC-3 Condition of Title Report to be ordered from the Secretary of State and approved by Buyer prior to close of escrow.

13.7 Seller to assign, and title to be subject to, all existing leases and rental agreements. [See **ft** Form 595]

a. Seller to notify each tenant of the change of ownership on or before the close of escrow. [See **ft** Form 554]

13.8 Security deposits held by Seller to be handed to Buyer on close of escrow. Seller to notify each tenant of the transfer of the security deposit on close of escrow, with a copy of each notice to Buyer through escrow. [See **ft** Form 586]

13.9 Delinquent unpaid rent to be treated as paid. Any recovery by Buyer of Seller's portion of delinquent rent and pro rated delinquent rent credited to Buyer shall be refunded to Seller on collection by Buyer.

13.10 Service and equipment contracts to be assumed by Buyer include ______________________________
____

a. Contracts assumed by Buyer to be pro rated to close of escrow.

13.11 Possession of the property and keys/access codes to be delivered on close of escrow.

13.12 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

14. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of ________________________ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _________:__________.

15.3 ☐ Attached is the Agency Law Disclosure. [See **ft** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. ____

____

____

____

Buyer's/ Selling Broker: ____________	Seller's/ Listing Broker: ____________
Broker's DRE Identification #: ____________	Broker's DRE Identification #: ____________
Selling Agent: ____________	Listing Agent: ____________
Agent's DRE Identification #: ____________	Agent's DRE Identification #: ____________
Signature: ____________	Signature: ____________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: ____________ ____________	Address: ____________ ____________
Phone: ____________	Phone: ____________
Fax: ____________	Fax: ____________
Email: ____________	Email: ____________

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______	Date: ____________, 20______
Buyer: ____________	Seller: ____________
Signature: ____________	Signature: ____________
Buyer: ____________	Seller: ____________
Signature: ____________	Signature: ____________

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: ____________, 20______

Name: ______________________________

Signature: ______________________________

Name: ______________________________

Signature: ______________________________

2. *Entire agreement*: **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price:

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment:* **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New trust deed loan:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly principal and interest (PI) payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

   4.1 *Buyer's loan qualification:* Check the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. Enter the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment.

   5.1 *Loan balance adjustments:* **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

   5.2 *Impound balances:* **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed:* **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and charge the unpaid amount to the seller.*

8. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

   8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

   8.2 *Carryback disclosure:* **Check** the box to indicate a Seller Carryback Disclosure Statement is attached as an addendum. [See **first tuesday** Form 300]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

   8.3 *Notice of Delinquency:* **Check** the box to indicate the buyer is to execute a Request for Notice of Delinquency and pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note.

   8.4 *Buyer creditworthiness:* **Requires** the buyer to provide the seller with a completed credit application.

   8.5 *Approval of creditworthiness:* **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

   8.6 *Subordination:* **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded.

   8.7 *Personal property as security:* **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note.

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

10. **Acceptance and performance periods:**

   10.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to his broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

   10.2 *Extension of performance dates:* **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

10.3 *Loan contingency:* **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

10.4 *Sale of other property:* If the closing of this transaction is to be contingent on the buyer's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the buyer.

10.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions.

10.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement.

10.7 *Mediation provision:* **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good-faith deposit tendered with the offer to buy.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

11. **Due Diligence Contingencies:**

11.1 *Approval period*: **Enter** the number of days the buyer has to approve or disapprove and cancel this agreement after the buyer's receipt of each item listed below. This section calls for the buyer to complete a due diligence investigation to confirm the representations of the seller and the seller's broker and the pre-contract expectations of the buyer about the property. If the buyer is unable to confirm his expectations, he may waive the requirements or cancel the transaction.

11.2 *Operating records:* **Requires** the seller to make income and expense records and supporting documents available to the buyer for inspection as soon as possible after acceptance of the offer.

11.3 *Rents and deposits:* **Requires** the seller to prepare a detailed rent roll profile on each occupancy and deliver it to the buyer as soon as possible after acceptance.

11.4 *Natural Hazard Disclosure (NHD) Statement:* **Requires** the seller to prepare and deliver to the buyer a NHD Statement disclosing the seller's knowledge of the hazards listed on the form.

11.5 *Condition of property:* **Requires** the seller to prepare and deliver a statement disclosing the physical condition of the property as known to the seller.

11.6 *Valuation inspection:* **Enter** the number of days after acceptance in which the buyer is to investigate the market value of the property to confirm its value justifies the price the buyer has agreed to pay.

11.7 *Title report:* **Requires** the seller to deliver a preliminary title report to the buyer for review to confirm the condition of title allows the buyer to use the property as he intended.

11.8 *Tenant Estoppel Certificate:* **Requires** the seller to produce Tenant Estoppel Certificates prior to seven days before the date scheduled for closing to confirm the tenants' acquiescence to the terms stated in the certificate.

11.9 *Tenant security:* **Requires** the seller to prepare and deliver a statement disclosing criminal activity affecting individuals on the property and any crime prevention undertaken or which should be undertaken.

11.10 *Due diligence contingencies:* **Check** the box to indicate the due diligence contingencies addendum for additional conditions is attached.

12. **Property Conditions:**

12.1 *Seller to furnish:* **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control:* **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report:* **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty:* **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance:* **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

f. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

12.2 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

12.3 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

12.4 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

Editor's note — Trade fixtures are personal property to be listed as items on an attached inventory at section 1.

12.5 *Leasing and lease modifications:* **Requires** the seller to obtain the buyer's consent (which will not be unreasonably withheld) to any new tenancies or modifications of existing tenancies entered into during the escrow period.

13. **Closing conditions:**

13.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction. [See **first tuesday** Form 401]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See Form 401]

13.2 *Closing date:* **Enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry.

13.3 *Title insurance*: **Provides** for the title to be vested in the name of the buyer or their assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the buyer or seller is to pay the title insurance premium.

13.4 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

13.5 *Prorates and adjustments:* **Authorizes** prorations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, loan balances, service contracts and other property operating expenses, prepaid or accrued.

a. *Supplemental property tax:* **Check** the box to indicate a notice of supplermental property tax bill has been prepared and attached.

13.6 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction at section 1.

a. *Personal property report*: **Check** the box to indicate escrow is to order a UCC-3 from the Secretary of State on any personal property located on the real estate which is to be transferred by bill of sale to the buyer.

13.7 *Assignment of leases:* **Requires** the seller to assign all leases and rental agreements to the buyer on closing. [See **first tuesday** Form 595]

a. *Ownership notice*: **Requires** the seller to notify each tenant of the change of ownership. [See **first tuesday** Form 554]

13.8 *Tenant security deposits:* **Requires** the seller to credit or pay the buyer on the close of escrow for security deposits held by the seller under the existing occupancies. **Requires** the seller to notify each tenant of the transfer of the security deposit. [See **first tuesday** Form 586]

Editor's note — Proper notice to the tenant regarding the security deposit transfer to the buyer eliminates all future liability the seller may have had due to the seller's original receipt of the deposits.

13.9 *Rent due and unpaid at closing:* **Treats** delinquent unpaid rent as paid for purposes of prorations. The buyer is credited for his share of paid and unpaid rents for the month of the closing. On any later recovery by the buyer of delinquent prorated rent, the buyer is to forward the entire amount received to the seller.

13.10 *Service contracts:* **Enter** the name of the providers of services under contracts the buyer is to assume.

a. *Prorations*: **Authorizes** the proration of amounts prepaid or unpaid on the service contracts.

13.11 *Buyer's possession:* **Requires** the seller to deliver possession of the property to the buyer on the close of escrow.

13.12 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage.

14. *Supplemental property tax bill*: **Notifies** the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership.

15. **Brokerage fee:**

15.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount of the fee may be stated as a fixed dollar amount or as a percentage of the price.

a. *Seller paid:* **Provides** that the seller will pay the brokerage fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the brokerage fee.

Editor's note — The defaulting party pays all brokerage fees and the brokerage fee can only be altered or cancelled by mutual instructions from the buyer and seller.

15.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive.

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the listing broker's MLS offer to a selling office to share a fee, or unilaterally by an agent when preparing the buyer's offer.

15.3 *Agency law disclosures:* **Check** the box to indicate a copy of the Agency Law Disclosure addendum for all parties to sign is attached. The disclosure is mandated to be acknowledged by

the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the brokers enforcing collection of the fee when the property involved contains one-to-four residential units. [See **first tuesday** Form 305]

15.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

16. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

Agency confirmation:

Buyer's broker identification: **Enter** the name of the buyer's broker and his DRE license number. **Enter** the name of any selling agent and his DRE license number. **Obtain** the signature of the buyer's broker or the selling agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the buyer's broker's address, telephone and fax numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and his DRE license number. **Enter** the name of any listing agent and his DRE license. **Obtain** the signature of the seller's broker or the listing agent acting on behalf of the seller's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the seller's broker's address, telephone and fax numbers, and email address.

Signatures:

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature.

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature.

Rejection of offer:

Should the offer contained in the purchase agreement be rejected instead of accepted, and the rejection will not result in a counteroffer, **enter** the date of the rejection and the names of the party rejecting the offer. **Obtain** the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **first tuesday** forms with maximum loss reduction protection, this purchase agreement **does not contain** clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. **Excluded provisions** include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit normal contracting;
- a *time-essence clause*, since future performance (closing) dates are, at best, estimates by the broker and his agents of the time needed to close and are too often **improperly used** by sellers in rising markets to cancel the transaction before the buyer or broker can reasonably comply with the

terms of the purchase agreement [See Chapter 27];

- an *arbitration provision*, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct [See Chapter 31]; and
- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable. [See Chapter 30]

Chapter 36 — Real estate purchase options

This chapter demonstrates the use and effect of option-to-buy agreements in real estate sales.

An irrevocable offer to sell

A real estate syndicator searching for investment-grade, income-producing real estate locates a property which appears to be financially suitable for a group investment, a real estate brokerage activity called *syndication*.

However, the syndicator will not commit himself to the purchase of the property until he has **fully investigated** the condition of the improvements, the property's operations and the availability of mortgage financing, an effort called *due diligence*.

Further, on completing his due diligence investigation, and if conditions are found to be acceptable, the syndicator will need additional time to prepare an **investment memorandum** and to **locate investors**. The memo will contain his narrative report on the significant information he has gathered concerning the worth of the property. The report will be circulated among equity investors as a solicitation to form a group to fund the acquisition of the property for long-term ownership.

First, before the syndicator begins his in-depth analysis of the property, he needs to enter into an enforceable purchase agreement with the seller. Without an agreement to acquire the property, the property may be sold to someone else before he can complete his investigation and determine the property is suitable for acquisition. For the same reasons, the syndicator chooses not to engage in the use of a letter of intent. [See **first tuesday** Form 185]

To acquire the right to buy the property without unconditionally committing himself to purchase the property, the syndicator submits an offer which calls for the occurrence of several events before he becomes committed to the purchase of the property in provisions called *contingency provisions*.

The **contingency provisions** include approval of the property's physical condition, its leasing income and operating expenses, available mortgage financing, title and zoning restrictions on use, and the existence of equity investors to fund the closing.

The seller fully understands the contingencies are designed primarily to enable the syndicator to confirm his understanding of the property's condition as represented by the seller and to obtain the mortgage and equity financing needed to fund the close of escrow. However, the seller is concerned the syndicator's inability to satisfy and remove the contingencies could interfere with the seller's ability to promptly cancel the agreement should the syndicator fail to close or cancel the transaction by the date scheduled for closing.

The seller decides not to accept the syndicator's purchase offer due to uncertainty regarding the syndicator's timely performance.

The option to buy as a counteroffer

However, the seller is willing to grant the syndicator an **option to buy** the property at the same price and for the same time period sought by the syndicator in his offer to purchase. Thus, the seller counters the offer.

Here, a counteroffer form will not be used to respond to the syndicator's offer. A counteroffer would incorporate the terms of the syndicator's purchase offer, subject to any modifications stated in the counteroffer.

In this situation, the seller simply prepares and hands the syndicator an **offer to grant an option**. Thus, the seller *rejects* the syndicator's offer in its entirety. [See Form 160 accompanying this chapter]

The seller's offer to grant an option requires the syndicator to accept the offer and the terms of the proposed option agreement before the seller is bound to deliver the signed option agreement. To accept the seller's offer to grant an option, the syndicator must sign the acceptance provision in the offer and return it to the seller. Of course, the acceptance must occur before expiration of the seller's offer to grant the option.

For the syndicator, his purchase of an option to buy property imposes no obligation on him to open escrow and purchase the property. Unlike a real estate purchase agreement, the buyer holding an option to buy has **no obligation to purchase** the property.

Conversely, the option contains the seller's irrevocable offer which **obligates the seller to sell** the property on the terms stated in the option agreement should the syndicator decide to buy the property within a set period of time, called the *option period*. The syndicator only agrees to buy the property when he **timely accepts** the seller's irrevocable offer to sell, an acceptance called *exercising the option*.

In exchange for the seller granting an option on the property, the syndicator will pay the seller *option money*. The amount of option money is the price the syndicator pays to **buy the option** and "tie up" the property by removing it from the market. [See Figure 1 accompanying this chapter]

Thus, the option agreement allows the syndicator to control the property without committing himself to purchase it until he exercises the option, if ever. His completion of the property analysis and solicitation of investors will indicate whether he will exercise the option or not.

However, when the syndicator exercises the option, a *bilateral sales contract* is automatically formed, no differently than had he accepted an offer from the seller to sell the property under a purchase agreement containing nearly identical terms. Thus, on exercise, both parties become obligated to perform as agreed and must proceed with closing the sale since no contingencies exist. [**Caras** v. **Parker** (1957) 149 CA2d 621]

Should the syndicator let the option period expire without exercising the option, the seller will be able to sell the property to another buyer, unaffected by the option since the seller's irrevocable offer to sell represented by the option has expired.

In an option agreement, the owner is referred to as the *optionor* and the potential buyer is referred to as the *optionee*. They become the seller and buyer, respectively, on exercise of the option.

Editor's note — An option granted to a buyer is to be distinguished from an exclusive right-to-sell listing granted to a broker. On entering into a listing, the seller incurs no obligation to sell the property to anyone. The owner has only employed the broker as his agent to find a buyer and represent the seller in negotia-

OFFER TO GRANT AN OPTION

and Option Money Receipt

NOTE: Recommended for use with **ft** Form 161 or 161-1.

DATE: ____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. On acceptance of this offer, ____, as the Optionor,
1.1 to grant, ____, as the Optionee,
1.2 an option to purchase property on terms and conditions set forth in the attached option agreement,
1.3 regarding property situated in the City of _________________, County of _______________, California,
1.4 referred to as ____.

TERMS:

2. This offer is conditioned on the tender of option money by Optionee in the sum of $_______________, evidenced by: ☐ cash, ☐ cashier's check, ☐ personal check, ☐ ______________________________, payable to Optionor to be held by Broker, undeposited, until delivery to Optionee of the option agreement signed by Optionor.

3. ☐ Parties to sign attached carryback disclosure statement which is a part of this agreement. (Mandatory if under the terms of the option, Optionor is to carry back paper on four-or-less residential units.) [See **ft** Form 300]

3.1 ☐ Optionee to hand Optionor a completed credit application on acceptance. [See **ft** Form 183] Optionor may terminate this agreement within ______ days of acceptance by delivering to Optionee, Optionee's Broker or Escrow, a written Notice of Cancellation based on disapproval of Optionee's credit. [See **ft** Form 183]

4. Seller's *Natural Hazard Disclosure Statement* [See **ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review, in which case Buyer may terminate the agreement within ten days of receipt based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance of this offer. [See **ft** Form 183]

5. On acceptance of this offer, the below mentioned Broker(s) are to be paid a fee of _______________ by ☐ Optionor, or ☐ Optionee. Optionor's Broker and Optionee's Broker, respectively, shall share the fee on the following ratio __________:__________.

6. This offer for option shall be deemed revoked unless accepted in writing by signing this offer and its attachment(s) and delivering same to the party making this offer or their broker on or before _____________, 20______.

OPTIONOR'S BROKER: ________________________
Broker's DRE Identification #: ____________________
Agent's Name: ________________________________
Agent's DRE Identification #: ____________________
Signature: __________________________________
Is the agent of: ☐ Optionor exclusively.
☐ Both Optionor and Optionee.
Address: ____________________________________
____
Phone: _________________ Fax: _________________
Email: ______________________________________

OPTIONEE'S BROKER: ________________________
Broker's DRE Identification #: ____________________
Agent's Name: ________________________________
Agent's DRE Identification #: ____________________
Signature: __________________________________
Is the agent of: ☐ Optionee exclusively.
☐ Both Optionor and Optionee.
Address: ____________________________________
____
Phone: _________________ Fax: _________________
Email: ______________________________________

OPTIONOR:

I agree to grant this option on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____________ 20______
Signature: __________________________________
Signature: __________________________________

OPTIONEE:

I accept this option on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____________, 20______
Signature: __________________________________
Signature: __________________________________

FORM 160 12-08

tions. The broker has not received the power-of-attorney authority needed to commit the seller to a sale of the property and the listing is not an offer to sell anything.

Granting an option

Consider a broker who is employed by a seller under a listing agreement which states the broker will receive a fee if he negotiates a sale, exchange or the grant of an **option to purchase** the seller's property. [See **first tuesday** Form 102 §10]

An agent of the broker locates a qualified buyer. The seller grants the buyer, also called an *optionee*, an option on the receipt of *option money* paid by the buyer. The broker receives no fee on the grant of the option, although he is entitled to a fee under the listing. Also, the option does not contain a fee provision.

After the listing expires, the buyer exercises the option and acquires the property.

The broker makes a demand on the seller for a fee under the listing agreement. The seller refuses, claiming the broker is not entitled to a fee since the buyer exercised the option after the listing agreement expired and the option did not provide for a fee on its exercise.

Here, the broker did earn a fee. During the listing period, the seller granted the buyer an option to buy the property, which the buyer later exercised to acquire the property. [**Anthony** v. **Enzler** (1976) 61 CA3d 872]

Thus, when an option is exercised, the sale relates back to the **time the option was granted**, i.e., during the listing period. This *relation back* is roughly comparable to entering into a purchase agreement or opening an escrow during the listing period, and closing the transaction after the listing expires.

Alternatively, consider a seller who agrees to pay a broker a partial fee on the granting of an option without any reference to payment of a further fee on the exercise of the option. To avoid the lost expectations of the payment of a further fee on exercise, the broker or his agent must then include a fee provision in the body of the option. [See Form 160 §6]

Benefits for opposing positions

An option agreement provides benefits for both buyer and seller.

A **buyer** should consider acquiring an option when:

- he does not yet want to commit himself to buy;
- he is speculating in a depressed market that values will soon rise;
- he needs time to investigate and determine whether the property will operate profitably;
- he needs time to do promotional work such as syndicating, subdividing, rezoning, obtaining permits or loan commitments, or to complete a §1031 reinvestment; or
- he is a tenant and may want to own the leased premises some day.

A **seller** should consider granting an option when:

- he wants to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- he wants to sell at a price based on higher future market values;
- he needs to provide an incentive to induce a prospective tenant to lease the property; or
- he wants to give a promoter incentive to work up a marketing or use plan and buy the property.

Figure 1

STANDARD OPTION TO PURCHASE
Irrevocable Right-to-Buy

DATE: ____________, 20_____, at ______________________________, California.
Items left blank or unchecked are not applicable.

1. **OPTION MONEY:**
   Optionor herewith receives from Optionee option money in the amount of $____________, evidenced by: ☐ cash, ☐ check, or ☐ ______________, given in consideration for this option to purchase real property.
2. **REAL PROPERTY UNDER OPTION:**
   Address ______________________________
   Legal description/Assessor's parcel number ______________________________
3. **ADDITIONAL CONSIDERATION:**
   As further consideration for this option, Optionee is to obtain at his expense and deliver to Optionor prior to expiration of this option the following checked items regarding the property:
   ☐ Property survey report by licensed California surveyors
   ☐ Architectural plans and specifications
   ☐ Zoning ordinance request
   ☐ On-site engineering plans
   ☐ Application for a parcel map or waiver
   ☐ Off-site improvement plans
   ☐ Soil engineer's report
   ☐ Land use study
   ☐ Application for a conditional use permit
   ☐ ______________________________
4. **OPTION PERIOD:**
   Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring ____________, 20_____, or ☐ on termination of the optionee's leasehold interest in the property.
5. **EXERCISE OF OPTION:**
   Optionee may exercise this option during the option period by:
   5.1 Signing escrow instructions identical in provisions to those attached as **Exhibit A** and delivering the instructions to escrow [See **ft** Form 401];
   5.2 Depositing cash in escrow of $____________; and
   5.3 Delivering an escrow-certified copy of the signed escrow instructions to Optionor within the option period, in person or by both certified and regular mail.
6. **ESCROW CONTRACT:**
   In the event this option is exercised, the transaction shall be escrowed with ______________________.
   6.1 Escrow shall close within _____ days after exercise.
7. **DELIVERY OF TITLE:**
   On Optionee's exercise of this option, Optionor shall timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.
8. **BROKERAGE FEE:**
   Optionor agrees to pay a brokerage fee of $____________, or _____% of the selling price, IF:
   8.1 This option is exercised;
   8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns or successors; or
   8.3 Optionor wrongfully prevents the exercise of this option;
   8.4 Payable to Broker(s) ______________________________

OPTIONOR'S BROKER: ____________	OPTIONEE'S BROKER: ____________
Broker's DRE Identification #: ____________	Broker's DRE Identification #: ____________
Agent's Name: ____________	Agent's Name: ____________
Agent's DRE Identification #: ____________	Agent's DRE Identification #: ____________
Signature: ____________	Signature: ____________
Is the agent of: ☐ Optionor exclusively. ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: ____________	Address: ____________
Phone: ____________ Fax: ____________	Phone: ____________ Fax: ____________
Email: ____________	Email: ____________

— PAGE ONE OF TWO — FORM 161 —

— PAGE TWO OF TWO — FORM 161 —

9. **SALE TERMS:**
   Price of $____________ payable as follows:
   9.1 ☐ All cash.
   9.2 Cash down payment in the amount of $____________.
   9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____________, with an unpaid principal balance of $____________, payable $____________ monthly, including interest not exceeding _____%, ☐ ARM, type ____________, plus a monthly tax/insurance impound payment of $____________. ____________
   a. At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
   b. The impound account to be transferred: ☐ charged, or ☐ without charge, to Optionee.
   9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____________, with an unpaid principal balance of $____________, payable $____________ monthly, including interest not exceeding _____%, ☐ ARM, type ____________, due ____________, 20_____.
   9.5 A note for the balance of the purchase price in the amount of $____________ to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $____________ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due ____________ years after closing.
   a. This note and trust deed to contain provisions to be provided by Optionor for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ____________
   b. ☐ The attached Carryback Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [See **ft** Form 300]
   c. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
10. **GENERAL PROVISIONS:**
   10.1 ☐ **See attached addendum for additional provisions.** [See **ft** Form 250]
   10.2 Attached as addenda are the following checked disclosures mandated on four-or-less residential units:
   a. ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **ft** Form 304]
   b. ☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
   c. ☐ Disclosure of sexual predator database [See **ft** Form 319]
   d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety [See **ft** Forms 313 and 315]
   e. ☐ Documentation on any Homeowners' Association (HOA) involved.
   f. ☐ Notice of Supplemental Property Tax Bill [See **ft** Form 317]
   10.3 Possession of the property to be delivered on: ☐ close of escrow, or ☐ see attached Occupancy Agreement. [See **ft** Forms 271 and 272]
   10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.
11. **EXPIRATION OF OPTION:**
   This offer to sell shall be deemed expired if not accepted by exercise during the option period.
   11.1 This option contract shall automatically terminate by expiration on ____________, 20_____.

I hereby grant this option and agree to the terms stated above.	**I hereby accept this option and agree to the terms stated above.**
Date: ____________, 20_____	Date: ____________, 20_____
Optionor: ____________	Optionee: ____________
Signature: ____________	Signature: ____________
Signature: ____________	Signature: ____________
Address: ____________	Address: ____________
Phone: ____________ Fax: ____________	Phone: ____________ Fax: ____________
Email: ____________	Email: ____________

FORM 161 01-09

Multiple option periods

Developers require a longer initial option period, or the right to extend the option period, to provide time in which to study a property, obtain government clearances and locate financing for development. If these objectives are met, the developer will be able to purchase the property on a previously agreed set of terms.

Thus, it is foreseeable a developer may need **additional time** beyond the initial option period to complete his due diligence and approval process before committing himself to the purchase of the "optioned" property. Here, the option agreement should include the right to buy one or more extensions of the option period on the payment of additional option money before the expiration of the preceding option period. [See **first tuesday** Form 161-1]

The developer who determines he will be unable to develop or to successfully market a development of the property will simply not exercise the option.

Lease with option

The other significant use of an option to buy relates to residential and nonresidential leasing arrangements. Prospective tenants might want the ability to later acquire ownership of the property they will be occupying.

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor the property to the tenant's needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements either by a lump sum, upfront expenditure or by payments amortized over the initial life of the lease as part of the monthly rent.

Also, installation of racks, cabinets, shelving, trade fixtures, lighting and other interior improvements will be needed to make the premises fully compatible for the tenant's occupancy. These too will be paid for by the tenant. Always, a degree of "goodwill" is built up with customers due to the location of the business on the property. Thus, the location becomes part of the value of the tenant's business so long as he remains at the location.

All these opportunities will be lost if the landlord refuses to extend the lease or his demands for increased rent under an option to extend the lease compels the tenant to relocate. A tenant with even a small degree of insight into his future operations at the location will attempt to negotiate some sort of option to purchase the property. At least an option to renew at lesser rental rates should be negotiated, as the tenant improvements (TIs) have been paid for by the tenant and the landlord has fully recovered any costs he may have incurred.

A lease with an option to purchase must be distinguished from the purchase rights held by a tenant under a right of first refusal agreement or a buyer under a lease-option sales arrangement. [See **first tuesday** Forms 163 and 579]

Option money as the consideration needed

An option agreement is not enforceable unless a seller receives some sort of consideration. Unless the seller is given something in exchange for the right he has *surrendered* to revoke his offer to sell or to sell the property to others, the option fails for *lack of consideration*. Without the payment of consideration, the agreement is merely an offer to sell which may be **withdrawn at any time** by the seller. [**Kowal** v. **Day** (1971) 20 CA3d 720]

While consideration is needed to create an option agreement which is binding on the seller, the **amount of the consideration** paid for an option may be a minimal amount. An enforceable option can be created for as little as 25 cents paid by a buyer.

Also, the consideration given for the option does not need to be in cash. For instance, when an option to purchase is granted to a tenant who enters into a lease, the consideration given for the grant of the option rights is the tenant's signature obligating the tenant to perform on the lease.

In the case of a syndicator or developer using an option to control property he is not yet certain he wants to purchase, the consideration is the option money paid to the seller to grant the irrevocable offer to sell. The option money is typically set at an amount which will compensate the seller for the time the property is kept off the market, similar to a payment of rent or interest (less any actual and implicit income produced for the owner by the property).

Often a small amount of option money is paid for a short initial option period, sometimes called a "free-look" period. The term of the free-look option may be twenty to thirty days, granted on the payment of a small amount of option money, such as $100.

If the buyer is given extensions to continue the option after the free-look period, he usually is required to put up a more substantial amount of option money.

Any number of additional option periods may be agreed to, one following the expiration of another. The number of extensions depends only on the seller's willingness to grant the extensions and the buyer's willingness to put up more option money to pay for those extensions. [See **first tuesday** Form 161-1]

Sufficiency of terms for enforcement

While consideration is necessary for a purchase option to be enforceable, a method for payment of the **purchase price** or a **closing date** are not.

Consider an owner and a tenant who sign a lease agreement granting the tenant an option to purchase the leased property.

The option includes the identities of both parties, a description of the property, and the price to be paid, but is silent on the escrow period for delivery of the price and deed after exercise of the option.

The tenant timely exercises the option and escrow is opened.

The owner responds by placing conditions on the escrow period not included in the option, negotiating to prolong the close of escrow until he locates a §1031 exchange replacement property.

The tenant counters, attempting to resolve the owner's demand for an **extended escrow** and his need to record a purchase-assist loan to fund the purchase price.

The owner then refuses to perform, claiming the option cannot be enforced since ongoing negotiations to resolve the time for payment of the price and delivery of the deed are essential terms and did not exist in the option.

Does the lack of terms regarding time for payment of the price and the delivery of the deed make the purchase option unenforceable?

No! An option agreement need only identify the parties involved, the property in question, and the price to be paid. When the option does not state the method for payment of the price or the length of the escrow

period, the method for payment of the price is *implied* to be cash through escrow, and the time for payment of the price in exchange for the deed is *implied* to be of a **reasonable time period** (60 days) after exercise of the option. [**Patel** v. **Liebermensch** (2008) 45 C4th 344]

Exercising the option

Unless a particular **manner for exercising** the option is specified in the option agreement, any communication from a buyer to a seller of his intention to exercise the option is sufficient. [**Riverside Fence Co.** v. **Novak** (1969) 273 CA2d 656]

However, if the option agreement requires the buyer to take specific steps to exercise the option, the buyer must follow the **conditions set** in order to exercise the option and acquire the property. [**Palo Alto Town & Country Village, Inc.** v. **BBTC Company** (1974) 11 C3d 494]

For instance, an option agreement should require a buyer to sign escrow instructions and deposit cash in escrow to exercise the option. If the instructions are not signed, or if signed and the deposit is not made, the option has not been exercised. Thus, the buyer has not exercised his right to acquire the property.

Proposed escrow instructions should be prepared and attached as an addendum to the option agreement to avoid any conflict over the content of the instructions required to be entered into to exercise the option. The instructions will remain unnumbered, undated and unsigned until exercise of the option. [See **first tuesday** Form 401]

The escrow opened to exercise an option should call for escrow to close within a short period of time, i.e., the number of days required to prepare documents, order title reports and close. Unless an option agreement requires the buyer to sign escrow instructions, deposit funds and close escrow within a short period of time, the buyer's exercise of the option merely creates an enforceable bilateral purchase agreement with no escrow, funds or clear closing date.

Recording the option

When a purchase option or **memorandum** of the option is recorded, it becomes part of the property's chain of title, imparting *constructive notice* of the outstanding option rights to anyone later obtaining an interest in the property. A buyer, lender or tenant acquiring an interest in the property with **actual or constructive notice** of the existence of an option to purchase the property takes his interest in the property **subject to** the buyer's option rights.

Conversely, a buyer, lender or tenant who does not have actual knowledge of an unrecorded and unexpired option, takes his interest in the property free of the option.

For example, a seller grants a buyer an option to purchase property. Before the option is recorded or the buyer takes possession, the seller conveys the property to a second buyer. The second buyer did not have actual knowledge of the first buyer's option on the property.

The buyer who was granted the option later exercises the option by depositing the full amount of the purchase price into an escrow he has opened as agreed in the option agreement.

However, the seller who granted the option is no longer the owner of the property. Thus, he has no interest in the property to convey. Also, the option agreement is not enforceable against the second buyer since the second buyer, who is now the owner of the property, had no knowledge of the first buyer's option when he acquired ownership.

Thus, the conveyance of the property to the second buyer without notice of the unexpired option wiped out the first buyer's right to buy the property under the option. [**Utley** v. **Smith** (1955) 134 CA2d 448]

A recorded option **ceases to constitute constructive notice** of a buyer's option rights when:

- six months have run after the expiration date stated in the recorded option agreement or memorandum without the prior recording of an *exercise* or *extension* of the option; or
- six months have run after the option or memorandum was recorded should the expiration date not be stated in the recorded option agreement or memorandum. [Calif. Civil Code §884.010]

The purpose for the extinguishment of the recorded option from title is to protect buyers and sellers of property from old, unexercised and expired option rights which are of record. No such statutory scheme exists for the "outlawing" of unrecorded options which have expired.

Chapter 37 — Home loan interest deductions

This chapter highlights the home loan interest deduction for reporting the tax consequences of financing first and second homes.

Two deductions, two residences

The federal government has a long-standing policy of encouraging residential tenants to **become homeowners**. The incentive the government offers to tenants is in the form of a significant reduction in the income taxes tenants will pay when they buy a home which will be their principal residence and finance the purchase.

For a tenant considering his income taxes, the monthly payment on a purchase-assist home loan is not just a substitute for his monthly rent payment, it also reduces his combined state and federal taxes by an amount equal to 20% to 30% of the monthly loan payment.

Real estate agents handling the sale or purchase of single-family residences must be able to intelligently discuss this tax reduction incentive with tenants to convert them into homeowners.

Due to the special **home loan interest deduction** rule for income tax reporting, the interest **accrued and paid** on loans is deductible from income as an *itemized expense* if:

- the loans **funded the purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home; and
- the loans are **secured** by either the owner's principal residence or second home.

Only loans secured by either the **first or second home** come under the home loan interest deduction rules. [Internal Revenue Code §163(h)(4)(A)(i)]

Without the home loan interest deduction rule, interest paid on a loan which funded the purchase or improvement of a principal residence or second home is not deductible since the loan funded a *personal expense*, not the acquisition of a business or investment.

Also, interest paid on **equity loans** secured by the first or second residence is deductible under the home loan interest deduction rules, regardless of whether the loan's net proceeds were used for personal or investment/business purposes.

The first/second home loan interest deduction reduces taxable income as an *itemized deduction* under both the standard income tax (SIT) and alternative minimum tax (AMT) reporting rules. In contrast, the real estate **property tax deduction** on the first and second homes applies only to reduce the owner's SIT, not his AMT.

Two categories of loans exist to allow the deduction of interest paid on any loans secured by the first or second home:

- interest on **purchase or improvement loan** balances up to a combined principal amount of $1,000,000; and
- interest on all other loan amounts up to an additional $100,000 in principal, called **home equity** loans.

Purchase/improvement loans

Interest paid on money loans and carryback credit sales originated to **purchase or substantially improve** an owner's first or second home, if secured by either home, is **fully deductible** on:

- combined loan balances up to $1,000,000 for an individual and for couples filing a joint return; and
- $500,000 for married persons filing separately.

Thus, if the loan funds used to acquire, construct or further improve a principal residence or second home collectively exceed $1,000,000, only the interest paid on $1,000,000 of the purchase and improvement loan balances is deductible as purchase/improvement interest. However, interest paid on the excess loan amounts, up to an additional $100,000, qualifies for the interest deduction as a home equity loan.

To qualify home improvement loans for the interest deductions, the new improvements must be *substantial*. Improvements are substantial if they:

- **add** to the residence's market value;
- **prolong** the residence's useful life; or
- **adapt** the property to residential use.

Loan funds spent on repairing and maintaining the residence to keep it in good condition do not qualify as funding for substantial improvements. [IRC §163(h)(3)(B)(i)]

Refinancing limitations

Should an owner refinance a purchase/improvement loan, the portion of the **refinancing** used to fund the payoff qualifies as a purchase/improvement loan for interest deductions. However, interest may be written off only on the amount of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement loan.

For example, an owner borrows $200,000 to fund the purchase of his principal residence. The loan balance is later paid down to $180,000. The owner refinances the residence, paying off the original purchase/improvement loan. However, the new loan is for a greater amount than the payoff demand on the old loan.

Here, interest on only $180,000 of the refinancing is deductible as interest paid on a purchase or improvement loan, **unless**:

- the excess funds generated by the refinance are **used to improve** the residence; or
- the excess loan amount **qualifies as a home equity loan** under its separate ceiling of $100,000 in principal.

$100,000 home equity loans

Interest on loan amounts secured by the first or second home may not qualify for the purchase/improvement home loan interest deduction, due either to a different use of the loan proceeds or the $1,000,000 loan limitation. However, the interest on loan amounts which do not qualify as purchase/improvement loans is deductible by individuals and those couples filing joint returns as interest paid on additional or other loan amounts up to $100,000 in principal, called *home equity loans*.

For married persons filing separately, the cap for the principal amount of equity loans on which interest can be deducted is limited to $50,000. [IRC §163(h)(3)(C)(ii)]

Home equity loans are typically junior encumbrances, but also include proceeds from a refinance which are not used to improve the proeprty or remain after a pay off of an existing purchase/improvement loan.

The proceeds from home equity loans may be used for **any purpose**, including personal uses unrelated to the property.

Property value ceiling

Interest paid on any portion of loan balances which exceeds the *fair market value* of the residence is not deductible. In practice, the fair market value rule applies to home equity loans and any refinancing which is greater than the amount needed to pay off an existing purchase/improvement loan. [IRC §163(h)(3)(C)(i)]

The **fair market value** of each residence is *presumed* to be the original amount of the purchase and improvement costs. Thus, any future **drop in property value** below the balance remaining on purchase-assist loans does not affect the interest write-off.

Editor's note — Consistent with its policy under codes such as Internal Revenue Code (IRC) §1031, the Internal Revenue Service (IRS) wants to stay out of the appraisal business. Thus, the IRS has substituted the easily computable original cost of purchase and improvements for the "fair market value" limitation established by Congress. However, an owner who takes out a home equity loan which, when added to the other loan balances on the residences exceeds his purchase and improvement costs of the property, can rebut the IRS fair market value presumption of cost with a current fair market value appraisal provided by the lender.

*Thus, on a refinance or origination of an equity loan, it is advisable to request and receive a copy of the lender's appraisal to later corroborate the property's increased value at the time the financing is originated. [See **first tuesday** Form 200-3]*

Qualifying the first/second home

To qualify for the home loan interest deduction, the loans must be secured by the owner's principal residence or his second home.

A **principal residence** is an individual's home, defined as a dwelling where the homeowner's immediate family resides a majority of the year, which is close to the homeowner's place of employment and banks handling the homeowner's accounts, and is the address used for tax returns.

The **second home** is any residence selected from year to year by the owner, including mobile homes, recreational vehicles and boats.

If the second home is **rented out** during portions of the year, the interest on purchase/improvement loans encumbering the second home qualifies for the home loan interest deduction if the owner occupied the home for more than 14 days or 10% of the number of days the residence was rented, which ever is greater. [IRC §280A(d)(1)]

If the owner does not rent out his second home at any time during the year, it qualifies for the home loan interest deduction whether or not he occupies it. [IRC §163(h)(4)(A)(iii)]

The rental income on the second home is *investment/portfolio income* if the home qualifies for the interest deduction since the owner's occupancy exceeded the 10%/14-day rule.

When the second home has been rented, but the owner's family has occupied the property for so many days as to qualify the home for the loan interest deduction, the owner is not allowed to treat the property as an investment. Thus, the owner cannot depreciate the home. [IRC §§163(h)(4)(A)(i)(II); 280A(d)(1)]

A second home, when purchased for personal use and held for a profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031. [IRC §1221; IRS Private Letter Ruling 8103117]

Taking the deductions

Interest deductions on home loans are only allowed for interest which has **accrued and been paid**, called *qualified interest*. [IRC §163(h)(3)(A)]

Interest on first and second home loans is deducted from the owner's **adjusted gross income** (AGI) as an *itemized deduction*, which also has further limitations on the total amount of all deductions. Conversely, business, rental or investment interest are adjustments that reduce the AGI. Thus, the two first/second home loan interest deductions directly reduce the amount of the owner's taxable income, if the interest paid is not limited by ceilings on itemized deductions.

The inability to reduce the AGI by use of the home loan interest makes a difference. The higher an owner's AGI, the lower the amounts allowed for some rental deductions, the itemized deduction phaseout (starting at an AGI of $142,700 for 2004), and any tax credits available to the owner.

Consider a homeowner who wants to generate funds for use as a down payment to purchase business, rental or investment real estate. His only substantial asset is the $300,000 equity in his home.

If the owner further finances (with a home equity loan) or refinances the existing loan to net $200,000 in loan proceeds, he will be paying interest which is only partially deductible. The non-purchase/improvement loan amount exceeds the $100,000 home equity loan cap. The interest the owner pays on the portion of home equity loan balance in excess of $100,000 is not deductible under the home loan interest deduction rules.

Mortgage insurance premiums, such as for private mortgage insurance (PMI), is also tax deductible. Treated the same as interest on a principal residence, a married couple filing a joint tax return with an AGI up to $100,000 (or an individual filing with an AGI up to $50,000) can deduct 100% of the mortgage insurance premiums paid or accrued on property purchased *after January 1, 2007*.

The amount of mortgage insurance premiums deductible is reduced by 10% with each additional $1,000 of AGI over $100,000 for joint filings up to $110,000, and over $50,000 for individuals up to $55,000. Any amounts paid or accrued *after December 31, 2010* or allocable to any period after that time cannot be deducted. [IRC §163(h)(3)(E)]

The home as additional security

Consider a homeowner who encumbers the equity in his home to secure a note he executes as the down payment, or to borrow funds for a down payment, on the purchase of investment property.

The homeowner wants to avoid the home loan interest deduction limitations and be able to write off all of the interest paid on the note against future income from the rental or portfolio property purchased. Accordingly, the homeowner negotiates with the lender or carryback seller for the note to be secured by **two separate trust deeds**, one as a lien on the home and the other as a lien on the property purchased.

The lender or carryback seller is satisfied with the financial risk regarding the loss of principal. The lender or the carryback seller receives a trust deed on the home, which he views as his primary source of recovery on the note.

However, the note is also secured by the property purchased in order to justify writing off the entire interest accrued and paid on the loan against income from the property purchased. Here, the home is merely **additional security** under a separate trust deed.

Chapter 38 The principal residence profit exclusion

This chapter analyzes the tax scheme for excluding profits from taxation on the sale of a residential property presently or previously used as the owner's principal residence.

Tax-free sale up to $250,000 per owner

Consider the seller of a residential property which he currently occupies or previously occupied, in part or in whole, as his principal residence. The price sought is far greater than the seller's *cost basis* in the property, which is comprised of:

- the price the seller paid for the property several years ago; and
- the costs incurred to renovate and improve the property.

The seller's listing agent is interested in the client's tax aspect of the sale. From information contained in the property profile provided by a title company, he determines the number of years the seller has owned the property and whether the seller has a homeowner's property tax exemption.

When counseling with the seller, the listing agent further determines the seller has used the property as his principal residence for at least two years during the past five years.

The seller is informed that each owner-occupant is qualified to take up to $250,000 in profit on the sale tax free if each occupied a portion or all of the property as his principal residence for at least two years during his last five years of ownership, whether or not:

- the seller originally acquired the property as a rental but has since occupied it;
- the seller now rents the property to tenants;
- the seller has taken depreciation deductions as his home office (or rental property); or
- the property consists of two or more residential or mixed-use units.

The listing agent agrees to **review the tax issues** relative to the seller's qualifying for the *principal residence profit exclusion*. He also checks out the availability of the §1031 exemption for profits allocated to a home office (business use) or separate rental space (investment property) in or about the residence, or due to the property's present status solely as a rental.

Questions for the **agent to consider** when undertaking the duty to advise on the tax aspects of the sale of what is or was the seller's principal residence include:

1. At the time of the sale, does the *property qualify* as the owner's **principal residence** under the two-out-of-five-year *principal residence rule*? [Internal Revenue Code §121(a)]
2. Who among the *co-owners qualifies* for the up to $250,000 profit exclusion as an **owner and occupant** for periods totaling two years during the five years preceding the close of the sale under the *principal residence rule*? [IRC §121(a)]
3. If only one spouse is the vested owner, does the **non-vested spouse qualify** as an owner by having occupied the property under the principal residence rule? [IRC §§121(b)(2), 121(d)(1)]
4. Is the **homeowner disqualified** for having taken a profit exclusion on the sale of a different principal residence which closed escrow within two years before the close of the sale on his current residence? [IRC §121(b)(3)]

5. If the period of owner-occupancy is less than two years, will the sale of the property be eligible for a **partial exclusion** as a result of *personal difficulties* which arose:
   - prior to completing **two full years** of ownership and occupancy; or
   - within two years after taking a profit exclusion on the sale of a prior principal residence? [IRC §§121(c)(1), 121(c)(2)]
6. What **percentage of the profit** taken on the sale, based on the *occupancy-to-ownership ratio*, can be excluded from taxation, limited to the $250,000 per person ceiling?
7. Did the homeowner **originally acquire** his residence as a rental property to replace other property he sold (or exchanged) in a §1031 reinvestment plan, and **later convert** it to his principal residence, triggering a **five-year holding period** that must pass before the principal residence profit exclusion is allowed? [IRC §121(d)(10)]
8. Does the homeowner **presently depreciate** a portion of the residence or the property as his home office or as a rental (duplex, etc.) and is the owner considering using some or all of the net sales proceeds to purchase like-kind §1031 property?
9. Did the homeowner take any **depreciation deductions** for his use of the property as his office or a rental after May 6, 1997 which must be reported as *unrecaptured gain* (25% tax), unless avoided by acquiring a replacement home office or rental in a §1031 reinvestment plan? [IRC §121(d)(6)]
10. Is the owner an unmarried surviving spouse who has not owned and occupied the property as a principal residence for the two-year period who can still qualify by **tacking** the deceased spouse's period of ownership and occupancy to the surviving owner's? [IRC §121(d)(2)]
11. If the owner is now in a government-licensed facility due to his physical or mental incapacity to care for himself and previously resided on the property for periods totaling at least one year during the past five years, does he qualify by **tacking** the time spent in the facility during his ownership of the property to satisfy the principal residency rule? [IRC §121(d)(7)]

Principal or second residence

Occasionally, a couple will have two or three residences that they occupy at different times during the year (a summer residence on the lake, a desert retreat, a residence in a prestigious community, etc.).

To **qualify a property** for the principal residence profit exclusion, the property must be **owned and occupied** as the owner's *principal residence* for at least two years during the five-year period prior to closing the sale. [IRC §§121(a), 121(b)(1)]

Factors which identify a property as the owner's principal residence include its:

- location near the owner's employment;
- use as the address listed on state and federal tax returns; and
- proximity to banks and professional services used by the owner.

Profit exclusion for sole owners and co-owners

The amount of profit (or loss) taken on a sale of real estate is set by subtracting the seller's cost basis in the property from the net sales price he receives — a formula of "price minus basis equals profit." Up to $250,000 if profit taken by an individual on the sale of his principal residence may qualify for the profit exclusion.

Each individual who owns a property, solely or with others, and who owned and occupied it as a principal residence for periods totaling **two of the five years** immediately preceding closing the sale, is eligible to exclude up to $250,000 of his profit on its sale.

Consider an individual who owns and occupies a property as his principal residence for no more than 23 months before closing a sale of the residence at a profit. No *personal difficulties* triggered his need to sell the property.

Does the individual qualify for the profit exclusion?

No! The individual did not occupy the property for a total of two years **within the five-year period** immediately preceding the sale, and no personal difficulties shortened the qualifying time. The time period limitation for ownership and occupancy must be met to exclude the profit from taxes. [IRC §121(a)]

Exclusion available to a married couple

A married couple **own and occupy** a property as their principal residence for at least two of the five years prior to closing a sale of the property. Unless disqualified by other events, they may exclude an **aggregate amount** of up to $500,000 in profit taken on the sale, i.e., $250,000 per person. [IRC §121(b)(2)(A)]

Alternatively, a husband and wife who do not both own and occupy a property as their principal residence may jointly qualify for up to a **combined $500,000** profit exclusion on the sale of their principal residence, if:

- either the husband or the wife **solely owns** the residence as separate property (or they are **co-owners)** since sole ownership by one spouse is **imputed** to the non-owner spouse;
- **both occupy** the property during the ownership for time periods totaling two years or more within the five-year period prior to the sale;
- the couple files a **joint return** as a married couple for the year of the sale; and
- neither spouse has taken a profit exclusion on another principal residence within two years prior to the sale. [IRC §121(b)(2)]

However, one spouse might be **individually disqualified** for having taken the principal residence profit exclusion on the sale of another residence which closed within the two-year period prior to closing the sale of the current residence. In this case, the combined exclusion of up to $500,000 is not available. However, the other spouse may separately qualify for an individual profit exclusion up to $250,000, whether or not he is a vested owner. [IRC §121(b)(2)(B)]

For example, a husband is the **sole owner** of a residence as his separate property. The husband and his wife **both occupy** the property as their principal residence during his ownership. They do so for a total of more than two years during the five years immediately preceding their sale of the property.

Neither spouse is disqualified for having taken a profit exclusion on the sale of a principal residence which closed escrow during the two-year period prior to closing. The couple files a joint return for the year of the sale.

Does each spouse qualify for the combined exclusion allowing the couple to exclude up to $500,000 of profit taken on the sale of the residence solely owned by one spouse?

Yes! The spouse who holds no ownership interest in the residence is an *imputed owner.* Thus, the couple is qualified for the profit exclusion since one spouse owns the property. Both, as required, occupied for the minimum two years within the five-year period prior to closing the sale.

No disqualifying marital taint

Consider a husband and wife who each independently owned and occupied separate principal residences for two years prior to their marriage.

On marriage, both the husband and wife vacate their prior residences and relocate to an entirely different property as their residence. Each spouse now needs to sell their prior residence.

The husband sells his prior residence at a profit. The couple files a joint return for the year of the sale.

Does the couple, now married, qualify for the combined exclusion of up to $500,000?

No! Only the husband qualifies to take the individual profit exclusion of up to $250,000 on the couple's joint tax return. While the wife did not need to be a vested owner of the husband's residence, she did have to occupy the property as her principal residence for two of the five years prior to his sale of the property to qualify the couple for the combined $500,000.

Further, and within two years after the husband closes the sale on his prior residence, the wife closes the sale of her prior residence at a profit. The wife, having owned and occupied her residence for two of the past five years, qualifies for an individual profit exclusion of up to $250,000. The husband and wife file a joint return for the year the wife sold her residence and claim the wife's individual profit exclusion.

Here, the wife is qualified to take the individual profit exclusion on the couple's joint return — even though the husband sold and took a profit exclusion within two years of her sale. [IRC §121(b)(3)(A)]

In contrast, consider a man who, either prior to or after getting married, closes escrow on the sale of his principal residence and takes a profit.

The man owned and occupied the principal residence for time periods totaling more than two years during the five years prior to closing the sale. The profit exclusion is qualified for and taken on the sale.

Since his marriage, both the man and his wife have occupied as their principal residence the wife's separate property for periods totaling at least two years within the past five years.

Less than two years after the husband closed the sale on which he took a profit exclusion, the residence owned by his wife is sold and escrow closed.

Can the couple file a joint return and qualify for the combined profit exclusion of up to $500,000 by reason of their marriage, the wife's separate ownership, and their shared occupancy of the residence?

No! Only the wife qualifies for an individual profit exclusion of up to $250,000 on their joint return.

Even though the husband met the (imputed) ownership and (actual) occupancy requirements for the property sold by his wife, the husband previously took a profit exclusion on the sale of his prior principal residence which closed within the two-year period preceding the closing of the sale of the wife's residence. Thus, the couple does not qualify for the combined profit exclusion of up to $500,000. [IRC §121(b)(3)(A)]

Similarly, had the second residence sold been community property and not separately owned by the wife, only the wife would have been allowed to take a profit exclusion on their joint return.

Closing the sale of the residence they both occupied should have been delayed to a date more than two years after the sale closed on the husband's residence. If the close of escrow on the second sale had been delayed, the couple would have qualified for the combined profit exclusion.

Personal difficulties compel the sale

Even if an individual or couple **cannot fully meet** the two-year ownership and occupancy requirements, they may still qualify to exclude all (or a portion) of their profit under a *partial exclusion* available to owners who sell due to **personal difficulties**.

The **partial exclusion** is a prorated portion of the profit exclusion, not a pro rata portion of the profit taken on the sale. The proration sets the maximum dollar amount of the partial exclusion available to cover any profits. The ratio applied to the exclusion to set the amount of the profit to be excluded is based on the fraction of the two years they have occupied the property.

To qualify for a partial exclusion, a personal difficulty must arise and be the **primary reason for sale** of the property, which includes:

- a **change in employment**, based on occupancy of the residence at the time of the job relocation and the financial need to relocate for the employment;
- a **change in health**, such as advanced age-related infirmities, severe allergies, or emotional problems; or
- **unforeseen circumstances**, such as natural or man-made disasters, death, and divorce. [IRC §121(c)(2)(B); Revenue Regulations §1.121-3]

Thus, when a homeowner must sell because of personal difficulties, all profit is excluded from taxation up to the ceiling amount of the partial exclusion set by that **fraction of two years** the owner actually owned and occupied the property as his principal residence. [IRC §121(c)(1)]

However, if the principal residence for which the owner seeks a partial exclusion was a rental acquired as a replacement property to complete a §1031 transaction using §1031 money or in exchange, the five-year *holding period* applies and must run before the §121 residential profit exclusion is available.

Factors used to determine whether the primary reason for the sale is a **change in circumstances** which qualifies the sale for a partial exclusion include:

- the sale of the principal residence and the need compelling the homeowner to relocate are close in time;
- a material change makes the property unsuitable as the principal residence;
- the homeowner's financial ability to carry the residence requires the residence be sold;
- the need to relocate arose during the occupancy of the residence sold; and
- the need to relocate was not foreseeable by the homeowner when he acquired and first occupied the principal residence sold. [Rev. Regs §1.121-3(b)]

For example, a *change in employment* may qualify the homeowner for the partial exclusion without first owning and occupying his principal residence for the full two-year period.

Employment compelling the homeowner to relocate can be based on a required job relocation by his current employer, the commencement of employment with a new employer, or if the homeowner is self-employed, the relocation of the place of business or the commencement of a new business.

A sale is deemed to be by reason of a **change in employment** if:

- the new job location is more than 50 miles farther than the old job was from the principal residence that was sold; or
- if the seller was formerly unemployed, the job location is at least 50 miles from the residence sold. [Rev. Regs. §1.121-3(c)]

For example, a homeowner is forced by his employment to relocate out of the area.

The homeowner has owned and occupied his principal residence for one year and six months — 75% of the necessary two-year occupancy period.

The homeowner sells his residence, taking a $40,000 profit.

When filing his tax return, the homeowner is eligible to exclude the entire $40,000 profit from taxation since the entire profit is less than the $187,500 partial exclusion (75% of the $250,000 full exclusion). The same ratio would apply to a couple's maximum $500,000 profit exclusion under the same circumstances. [IRC §121(c)]

Health issues of a chronic nature, which compel the homeowner to sell may qualify the sale for partial exclusion.

To qualify for reasons of health, the owner seeking the exclusion must need to sell in order to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of a disease, illness or injury, or obtain and provide medical or personal care, for any of the following persons:

- the owner himself;
- the owner's spouse;
- a co-owner of the residence;
- a co-occupant residing in the owner's household as his principal place of abode; or
- close relatives, generally those descendent of the owner's grandparents.

The owner's sale is also deemed to be due to health reasons if a physician recommends a change of residence (relocation). [Rev. Regs. §1.121-3(d)]

Unforeseen circumstances may arise and provide the primary reasons for the sale of the owner's principal residence, permitting use of the partial §121 exclusion of profit from taxation. Events which occur and are classified as unforeseen circumstances do not include events which could have been reasonably anticipated by the owner before he owned and occupied the residence.

Also, the **mere preference** of the owner to buy another property to own and occupy as his principal residence or the **financial improvement** of the owner permitting acquisition of another more affluent appearing residence does not qualify the sale for the partial §121 exclusion of profit.

However, the owner's sale is deemed to be due to **unforeseen circumstances** if:

- the residence is taken by an involuntary conversion; or
- disaster (natural or man-made) or acts of war/terrorism cause a casualty loss to the residence.

Further, the homeowner's sale is deemed to be due to **unforeseen circumstances** if the following events

occur to the owner, owner's spouse, co-owners, co-occupants who are residents and members of the owner's household and close relatives:

- death;
- loss of employment resulting in unemployment compensation;
- inability to pay housing costs and basic living expenses for the owner's household;
- divorce or separation by court decree; or
- a pregnancy with multiple births. [Rev. Regs. §1.121-3(e)]

Percentage limitation on profit excluded

Once the sale of a property qualifies for a profit exclusion by being **owned and occupied** as a principal residence for at least two years out of the five-year period prior to the sale of the property, the *percentage of the profit* that can be excluded from taxation must be determined.

The **percentage of the profit** excluded on a sale is based on an *occupancy-to-ownership ratio* covering the entire period of ownership, not just five years.

Periods the owner is considered to have **occupied** the property as his principal residence include:

- any period of ownership prior to January 1, 2009 [IRC §121(b)(4)[(5)](C)];
- any period of use as the owner's principal residence after January 1, 2009 prior to the sale; and
- any period after terminating his use of the property as a principal residence within the five years prior to the sale. [IRC §121(b)(4)[(5)](C)(ii)]

Consider an owner who purchases a property on January 1, 2005 for use as a second home. He first occupies it as his principal residence on January 1, 2011. He later moves out on January 1, 2013, terminating the property's use as his principal residence. The property is then sold, closing escrow on January 1, 2015, taking a $300,000 profit.

The issue is now, "how much of the $300,000 in profit can the owner exclude since he did not occupy the property at all times during his ownership?"

In analysis, the owner meets the initial two-out-of-five-year **principal residence requirement**.

The seller's **period of ownership** of the property is ten years.

The **period of occupancy** of the property as the owner's principal residence is eight years, based on:

- the four years prior to January 1, 2009, even though he did not occupy the property himself;
- the two years after January 1, 2009 when he actually occupied the property as his principal residence; and
- the two years after terminating his occupancy of the property as his principal residence up to the closing of the sale.

Thus, the **occupancy-to-ownership ratio** is 8:10, representing the eight years of occupancy over the ten years of ownership.

Here, eight-tenths (80%) of the $300,000 profit on the sale is $240,000. That amount of the profit is excludable from the owner's gross income since it does not exceed the **ceiling amount** of the $250,000 principal residence exclusion. [IRC §121(b)]

An orderly liquidation and §1031

Now consider a married couple who have, for the past two years, owned and occupied a home as their principal residence. They also own, either separately or as community property, several single-family residential rental properties.

The couple vacate their principal residence on December 31, 2011 when they close escrow on a sale of the property and take a profit. They file a joint tax return for the year of the sale and qualify for the combined profit exclusion.

The couple then move into another residential property they have owned since 2003, converting that property from a residential rental property into their principal residence.

On December 31, 2013, two years after occupying the second property as their principal residence, the couple close escrow on the sale of the property and take a profit. The couple file a joint tax return for the year of sale and claim the profit exclusion of up to $500,000 to avoid taxes on the profit since they qualify under the two-out-of-five-year principal residence rule.

However, the *occupancy-to-ownership ratio* for setting the percentage of the profit which is excludable must be established and applied to the profit they have taken.

The coupled had **owned** the second property at the time of sale for ten years (from 2003-2013). They occupied it as their principal residence for two years immediately prior to closing the sale. Here, eight years of the ten-year period of ownership is considered **occupied**, an occupancy-to-ownership ratio of 8:10 — six years pre-2009 and two years post-2008.

The years after 2008 before the property became the owner's principal residence limits the profit available for exclusion.

Thus, by repeating the two-year occupancy of single-family residences they own as their principal residence under either of the above scenarios, the couple is able to:

- liquidate their real estate holdings; and
- avoid paying tax on much of the profit taken on the sales.

Should the couple **carry back** a note and trust deed on the sale of one of the properties, the profit allocated to the principal in the note will be declared in the year of sale and excluded from taxation as part of the exclusion of profit on the sale.

However, if any property now occupied as the principal residence was acquired as a rental in a **§1031 reinvestment plan** and later converted into the principal residence of the owner, a **holding period of five years** must run before the owner may sell and qualify for the §121 residential exclusion. However, the two-year period for principal residency remains unchanged. [IRC §121(d)(10)]

For example, an individual or couple acquires a residence for business or investment property purposes as replacement property in a §1031 reinvestment plan. Later, the property is converted into their principal residence for the necessary two years.

Here, they must retain ownership of the residence for at least five years after acquiring it before a sale of the property will qualify for the profit exclusion available to each owner.

Occasionally, the homeowner will establish a home office within the residence or in a space separate from the residence, such as a granny flat, maids' quarters, or other rentable space on the same parcel

as the residence. The home office area is allocated its pro rata share of the cost basis, and depreciation deductions are reported.

On a sale of the property, the §121 profit exclusion is always applied first to the profit taken on the residential portion of the cost basis in the property, that portion of the profit and basis not allocated to the depreciable portion used as the home office.

If the home office is **within the space** of the residence, not separate from the residence in other quarters, the §121 profit exclusion applies to the home office space as well, called a *spillover*, except for the depreciation taken on the home office space. Not so for the home office located in **space separate** from the residence. Either way, the depreciation portion of the profit is taxed at the 25% maximum *unrecaptured gain* rate.

Also, the depreciable portion of the property used as the home office (or a separate rental) at the time of sale is §1031 property, entitled to have its pro rata share of net sales proceeds reinvested in other property to complete a §1031 plan. [Rev. Proc. 2005-14]